



8011-01

SECURITIES AND EXCHANGE COMMISSION

(Release No. 34-83748; File No. SR-NSCC-2017-806)

July 31, 2018

Self-Regulatory Organizations; National Securities Clearing Corporation; Notice of Filing of Amendment No. 1 to an Advance Notice to Amend the Loss Allocation Rules and Make Other Changes

On December 18, 2017, National Securities Clearing Corporation (“NSCC”) filed with the Securities and Exchange Commission (“Commission”) advance notice SR-NSCC-2017-806 (“Advance Notice”) pursuant to Section 806(e)(1) of Title VIII of the Dodd-Frank Wall Street Reform and Consumer Protection Act entitled the Payment, Clearing, and Settlement Supervision Act of 2010 (“Clearing Supervision Act”) and Rule 19b-4(n)(1)(i) under the Securities Exchange Act of 1934 (“Act”).<sup>1</sup> The notice of filing

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<sup>1</sup> 12 U.S.C. 5465(e)(1) and 17 CFR 240.19b-4(n)(1)(i), respectively. On December 18, 2017, NSCC filed the Advance Notice as a proposed rule change (SR-NSCC-2017-018) with the Commission pursuant to Section 19(b)(1) of the Act and Rule 19b-4 thereunder (“Proposed Rule Change”). (17 CFR 240.19b-4 and 17 CFR 240.19b-4, respectively.) The Proposed Rule Change was published in the Federal Register on January 8, 2018. See Securities Exchange Act Release No. 82428 (January 2, 2018), 83 FR 897 (January 8, 2018) (SR-NSCC-2017-018). On February 8, 2018, the Commission designated a longer period within which to approve, disapprove, or institute proceedings to determine whether to approve or disapprove the Proposed Rule Change. See Securities Exchange Act Release No. 82670 (February 8, 2018), 83 FR 6626 (February 14, 2018) (SR-DTC-2017-022; SR-FICC-2017-022; SR-NSCC-2017-018). On March 20, 2018, the Commission instituted proceedings to determine whether to approve or disapprove the Proposed Rule Change. See Securities Exchange Act Release No. 82910 (March 20, 2018), 83 FR 12968 (March 26, 2018) (SR-NSCC-2017-018). On June 25, 2018, the Commission designated a longer period for Commission action on the proceedings to determine whether to approve or disapprove the Proposed Rule Change. Therefore, September 5, 2018 is the date by which the Commission should either approve or disapprove the Proposed Rule Change. See Securities Exchange Act Release Nos. 83510 (June 25, 2018), 83 FR 30791 (June 29, 2018) (SR-DTC-2017-022; SR-FICC-2017-022; SR-NSCC-2017-018). On June 28, 2018, NSCC filed Amendment No. 1 to the Proposed Rule Change. See Securities Exchange Act Release No. 83633 (July 13, 2018), 83 FR 34227 (July

and extension of the review period of the Advance Notice was published for comment in the Federal Register on January 30, 2018.<sup>2</sup>

On April 10, 2018, the Commission required additional information from NSCC pursuant to Section 806(e)(1)(D) of the Clearing Supervision Act, which tolled the Commission's period of review of the Advance Notice.<sup>3</sup> On June 28, 2018, NSCC filed Amendment No. 1 to the Advance Notice to amend and replace in its entirety the Advance Notice as originally submitted on December 18, 2017, and on July 6, 2018, submitted a response to the Commission's request for additional information in consideration of the Advance Notice, which added a further 60-days to the review period pursuant to Section 806(e)(1)(E) and (G) of the Clearing Supervision Act.<sup>4</sup>

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19, 2018) (SR-NSCC-2017-018). As of the date of this release, the Commission has not received any comments on the Proposed Rule Change.

<sup>2</sup> Securities Exchange Act Release No. 82584 (January 24, 2018), 83 FR 4377 (January 30, 2018) (SR-NSCC-2017-806). Pursuant to Section 806(e)(1)(H) of the Clearing Supervision Act, the Commission may extend the review period of an advance notice for an additional 60 days, if the changes proposed in the advance notice raise novel or complex issues, subject to the Commission providing the clearing agency with prompt written notice of the extension. 12 U.S.C. 5465(e)(1)(H). The Commission found that the Advance Notice raised complex issues and, accordingly, extended the review period of the Advance Notice for an additional 60 days until April 17, 2018, pursuant to Section 806(e)(1)(H). Id.

<sup>3</sup> 12 U.S.C. 5465(e)(1)(D); See Memorandum from the Office of Clearance and Settlement Supervision, Division of Trading and Markets, titled "Commission's Request for Additional Information," available at <https://www.sec.gov/rules/sro/nscc-an.htm>.

<sup>4</sup> To promote the public availability and transparency of its post-notice amendment, NSCC submitted a copy of Amendment No. 1 through the Commission's electronic public comment letter mechanism. Accordingly, Amendment No. 1 has been posted on the Commission's website at <https://www.sec.gov/rules/sro/nscc-an.htm> and thus been publicly available since June 29, 2018. 12 U.S.C. 5465(e)(1)(E) and (G); see Memorandum from the

The Advance Notice, as amended by Amendment No. 1, is described in Items I and II below, which Items have been prepared by NSCC. The Commission is publishing this notice to solicit comments on the Advance Notice, as amended by Amendment No. 1, from interested persons.

I. Clearing Agency's Statement of the Terms of Substance of the Advance Notice

This Advance Notice consists of proposed modifications to NSCC's Rules and Procedures ("Rules") in order to amend provisions in the Rules regarding loss allocation as well as make other changes, as described in greater detail below.<sup>5</sup>

II. Clearing Agency's Statement of the Purpose of, and Statutory Basis for, the Advance Notice

In its filing with the Commission, the clearing agency included statements concerning the purpose of and basis for the Advance Notice and discussed any comments it received on the Advance Notice. The text of these statements may be examined at the places specified in Item IV below. The clearing agency has prepared summaries, set forth in sections A and B below, of the most significant aspects of such statements.

(A) Clearing Agency's Statement on Comments on the Advance Notice Received from Members, Participants, or Others

Written comments relating to this proposal have not been solicited or received. NSCC will notify the Commission of any written comments received by NSCC.

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Office of Clearance and Settlement Supervision, Division of Trading and Markets, titled "Response to the Commission's Request for Additional Information," available at <https://www.sec.gov/rules/sro/nsc-an.htm>.

<sup>5</sup> Capitalized terms not defined herein are defined in the Rules, available at [http://www.dtcc.com/~media/Files/Downloads/legal/rules/nsc\\_rules.pdf](http://www.dtcc.com/~media/Files/Downloads/legal/rules/nsc_rules.pdf).

(B) Advance Notice Filed Pursuant to Section 806(e) of the Clearing Supervision Act

Description of Amendment No. 1

This filing constitutes Amendment No. 1 (“Amendment”) to Advance Notice previously filed by NSCC on December 18, 2017.<sup>6</sup> This Amendment amends and replaces the Advance Notice in its entirety. NSCC submits this Amendment in order to further clarify the operation of the proposed rule changes on loss allocation by providing additional information and examples. In particular, this Amendment would:

- (i) Clarify which Members would be subject to loss allocation with respect to Defaulting Member Events (as defined below and in the proposed rule change) and Declared Non-Default Loss Events (as defined below and in the proposed rule change) occurring during an Event Period (as defined below and in the proposed rule change). Specifically, pursuant to the Amendment, proposed Section 4 of Rule 4 would provide that each Member that is a Member on the first day of an Event Period would be obligated to pay its pro rata share of losses and liabilities arising out of or relating to each Defaulting Member Event (other than a Defaulting Member Event with respect to which it is the Defaulting Member (as defined below and in the proposed rule change)) and each Declared Non-Default Loss Event occurring during the Event Period. Proposed Section 4 of Rule 4 would also make it clear that any Member for which NSCC ceases to act on a non-business day, triggering an Event Period that

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<sup>6</sup> See Securities Exchange Act Release No. 82584 (January 24, 2018), 83 FR 4377 (January 30, 2018) (SR-NSCC-2017-806).

commences on the next business day, would be deemed to be a Member on the first day of that Event Period.

- (ii) Clarify the obligations and Loss Allocation Cap (as defined below and in the proposed rule change) of a Member that withdraws from membership in respect of a loss allocation round. Specifically, pursuant to the Amendment, proposed Section 6 of Rule 4 would provide that the Member would nevertheless remain obligated for its pro rata share of losses and liabilities with respect to any Event Period for which it is otherwise obligated under Rule 4; however, its aggregate obligation would be limited to the amount of its Loss Allocation Cap as fixed in the round for which it withdrew.
- (iii) Clarify that a Member would be obligated to NSCC for all losses and liabilities incurred by NSCC arising out of or relating to any Defaulting Member Event with respect to the Member. Specifically, pursuant to the Amendment, proposed Section 4 of Rule 4 would provide that each Member would be obligated to NSCC for the entire amount of any loss or liability incurred by NSCC arising out of or relating to any Defaulting Member Event with respect to such Member.
- (iv) Clarify that, although a Defaulting Member would not be allocated a ratable share of losses and liabilities arising out of or relating to its own Defaulting Member Event, it would remain obligated to NSCC for all such losses and liabilities. Specifically, pursuant to the Amendment, proposed

Section 10 of Rule 4 would provide that no loss allocation under Rule 4 would constitute a waiver of any claim NSCC may have against a Member for any loss or liability to which the Member is subject under the Rules, including, without limitation, any loss or liability to which it may be subject under Rule 4.

In addition, pursuant to the Amendment, NSCC is making other clarifying and technical changes to the proposed rule change, as proposed herein.

*Nature of the Proposed Change*

The primary purpose of this proposed rule change is to amend NSCC's loss allocation rules in order to enhance the resiliency of NSCC's loss allocation process so that NSCC can take timely action to address multiple loss events that occur in succession during a short period of time (defined and explained in detail below). In connection therewith, the proposed rule change would (i) align the loss allocation rules of the three clearing agencies of The Depository Trust & Clearing Corporation ("DTCC"), namely The Depository Trust Company ("DTC"), Fixed Income Clearing Corporation ("FICC") (including the Government Securities Division ("FICC/GSD") and the Mortgage-Backed Securities Division ("FICC/MBSD")), and NSCC (collectively, the "DTCC Clearing Agencies"), so as to provide consistent treatment, to the extent practicable and appropriate, especially for firms that are participants of two or more DTCC Clearing Agencies, (ii) increase transparency and accessibility of the loss allocation rules by enhancing their readability and clarity, (iii) reduce the time within which NSCC is required to return a former Member's Clearing Fund deposit, (iv) increase clarity of the voluntary termination provisions, and (v) make conforming and technical changes.

(i) Background

Central counterparties (“CCPs”) play a key role in financial markets by mitigating counterparty credit risk on transactions between market participants. CCPs achieve this by providing guaranties to participants and, as a consequence, are typically exposed to credit risks that could lead to default losses. In addition, in performing its critical functions, a CCP could be exposed to non-default losses that are otherwise incident to the CCP’s clearance and settlement business.

A CCP’s rulebook should provide a complete description of how losses would be allocated to participants if the size of the losses exceeded the CCP’s pre-funded resources. Doing so provides for an orderly allocation of losses, and potentially allows the CCP to continue providing critical services to the market and thereby results in significant financial stability benefits. In addition, a clear description of the loss allocation process offers transparency and accessibility to the CCP’s participants.

*Current NSCC Loss Allocation Process*

As a CCP, NSCC’s loss allocation process is a key component of its risk management process. Risk management is the foundation of NSCC’s ability to guarantee settlement, as well as the means by which NSCC protects itself and its Members from the risks inherent in the clearance and settlement process. NSCC’s risk management process must account for the fact that, in certain extreme circumstances, the collateral and other financial resources that secure NSCC’s risk exposures may not be sufficient to fully cover losses resulting from the liquidation of the portfolio of a Member for whom NSCC has ceased to act.<sup>7</sup>

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<sup>7</sup> When NSCC restricts a Member’s access to services generally, NSCC is said to have “ceased to act” for the Member. Rule 46 (Restrictions on Access to

The Rules currently provide for a loss allocation process through which both NSCC (by applying no less than 25% of its retained earnings in accordance with Addendum E) and its Members would share in the allocation of a loss resulting from the default of a Member for whom NSCC has ceased to act pursuant to the Rules. The Rules also recognize that NSCC may incur losses outside the context of a defaulting Member that are otherwise incident to NSCC's clearance and settlement business.

NSCC's loss allocation rules currently provide that in the event NSCC ceases to act for a Member, the amounts on deposit to the Clearing Fund from the defaulting Member, along with any other resources of, or attributable to, the defaulting Member that NSCC may access under the Rules (e.g., payments from Clearing Agency Cross-Guaranty Agreements), are the first source of funds NSCC would use to cover any losses that may result from the closeout of the defaulting Member's guaranteed positions. If these amounts are not sufficient to cover all losses incurred, then NSCC will apply the following available resources, in the following loss allocation waterfall order:

First, as provided in Addendum E, NSCC's corporate contribution of at least 25 percent of NSCC's retained earnings existing at the time of a Member impairment, or such greater amount as the Board of Directors may determine; and Second, if a loss still remains, as and in the manner provided in Rule 4, the required Clearing Fund deposits of Members who are non-defaulting Members on the date of default.

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Services) sets out the circumstances under which NSCC may cease to act for a Member, and Rule 18 (Procedures for When the Corporation Declines or Ceases to Act) sets out the types of actions NSCC may take when it ceases to act for a Member. Supra note 5.



Pursuant to current Section 5 of Rule 4, if, as a result of applying the Clearing Fund deposit of a Member, the Member's actual Clearing Fund deposit is less than its Required Deposit, it will be required to eliminate such deficiency in order to satisfy its Required Deposit amount. Pursuant to current Section 4 of Rule 4, Members can also be assessed for non-default losses incident to the operation of the clearance and settlement business of NSCC. Pursuant to current Section 8 of Rule 4, Members may withdraw from membership within specified timeframes after a loss allocation charge to limit their obligation for future assessments.

#### Overview of the Proposed Rule Changes

##### A. Changes to Enhance Resiliency of NSCC's Loss Allocation Process

In order to enhance the resiliency of NSCC's loss allocation process, NSCC proposes to change the manner in which each of the aspects of the loss allocation waterfall described above would be employed. NSCC would retain the current core loss allocation process following the application of the defaulting Member's resources, i.e., first, by applying NSCC's corporate contribution, and second, by pro rata allocations to Members. However, NSCC would clarify or adjust certain elements and introduce certain new loss allocation concepts, as further discussed below. In addition, the proposed rule change would address the loss allocation process as it relates to losses arising from or relating to multiple default or non-default events in a short period of time, also as described below.

Accordingly, NSCC is proposing five (5) key changes to enhance NSCC's loss allocation process:

(1) Changing the calculation and application of NSCC's corporate contribution.

As stated above, Addendum E currently provides that NSCC will contribute no less than 25% of its retained earnings (or such higher amount as the Board of Directors shall determine) to a loss or liability that is not satisfied by the impaired Member's Clearing Fund deposit. Under the proposal, NSCC would amend the calculation of its corporate contribution from a percentage of its retained earnings to a mandatory amount equal to 50% of the NSCC General Business Risk Capital Requirement.<sup>8</sup> NSCC's General Business Risk Capital Requirement, as defined in NSCC's Clearing Agency Policy on Capital Requirements,<sup>9</sup> is, at a minimum, equal to the regulatory capital that NSCC is required to maintain in compliance with Rule 17Ad-22(e)(15) under the Act.<sup>10</sup> The proposed Corporate Contribution (as defined in the proposed rule change) would be held in addition to NSCC's General Business Risk Capital Requirement.

Currently, the Rules do not require NSCC to contribute its retained earnings to losses and liabilities other than those from Member impairments. Under the proposal, NSCC would apply its corporate contribution to non-default losses as well. The proposed Corporate Contribution would apply to losses arising from Defaulting Member Events and Declared Non-Default Loss Events (as such terms are defined below and in the

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<sup>8</sup> NSCC calculates its General Business Risk Capital Requirement as the amount equal to the greatest of (i) an amount determined based on its general business profile, (ii) an amount determined based on the time estimated to execute a recovery or orderly wind-down of NSCC's critical operations, and (iii) an amount determined based on an analysis of NSCC's estimated operating expenses for a six (6) month period.

<sup>9</sup> See Securities Exchange Act Release No. 81105 (July 7, 2017), 82 FR 32399 (July 13, 2017) (SR-NSCC-2017-004).

<sup>10</sup> 17 CFR 240.17Ad-22(e)(15).

proposed rule change), and would be a mandatory contribution by NSCC prior to any allocation of the loss among NSCC's Members.<sup>11</sup> As proposed, if the Corporate Contribution is fully or partially used against a loss or liability relating to an Event Period, the Corporate Contribution would be reduced to the remaining unused amount, if any, during the following two hundred fifty (250) business days<sup>12</sup> in order to permit NSCC to replenish the Corporate Contribution.<sup>13</sup> To ensure transparency, Members would receive notice of any such reduction to the Corporate Contribution.

As compared to the current approach of applying "no less than" a percentage of retained earnings to defaulting Member losses, the proposed Corporate Contribution would be a fixed percentage of NSCC's General Business Risk Capital Requirement, which would provide greater transparency and accessibility to Members. The proposed Corporate Contribution would apply not only towards losses and liabilities arising out of or relating to Defaulting Member Events but also those arising out of or relating to

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<sup>11</sup> The proposed rule change would not require a Corporate Contribution with respect to the use of the Clearing Fund as a liquidity resource; however, if NSCC uses the Clearing Fund as a liquidity resource for more than 30 calendar days, as set forth in proposed Section 2 of Rule 4, then NSCC would have to consider the amount used as a loss to the Clearing Fund incurred as a result of a Defaulting Member Event and allocate the loss pursuant to proposed Section 4 of Rule 4, which would then require the application of a Corporate Contribution.

<sup>12</sup> Rule 1 defines "business day" as "any day on which the Corporation is open for business. However, on any business day that banks or transfer agencies in New York State are closed or a Qualified Securities Depository is closed, no deliveries of securities and no payments of money shall be made through the facilities of the Corporation." Supra note 5.

<sup>13</sup> NSCC believes that two hundred and fifty (250) business days would be a reasonable estimate of the time frame that NSCC would require to replenish the Corporate Contribution by equity in accordance with NSCC's Clearing Agency Policy on Capital Requirements, including a conservative additional period to account for any potential delays and/or unknown exigencies in times of distress.

Declared Non-Default Loss Events, which is consistent with the current industry guidance that “a CCP should identify the amount of its own resources to be applied towards losses arising from custody and investment risk, to bolster confidence that participants’ assets are prudently safeguarded.”<sup>14</sup>

Under the current Addendum E, NSCC has the discretion to contribute amounts higher than the specified percentage of retained earnings, as determined by the Board of Directors, to any loss or liability incurred by NSCC as result of a Member’s impairment. This option would be retained and expanded under the proposal so that it would be clear that NSCC can voluntarily apply amounts greater than the Corporate Contribution against any loss or liability (including non-default losses) of NSCC, if the Board of Directors, in its sole discretion, believes such to be appropriate under the factual situation existing at the time.

The proposed rule changes relating to the calculation and application of the Corporate Contribution are set forth in proposed Sections 4 and 5 of Rule 4, as further described below.

## (2) Introducing an Event Period.

In order to clearly define the obligations of NSCC and its Members regarding loss allocation and to balance the need to manage the risk of sequential loss events against Members’ need for certainty concerning their maximum loss allocation exposures, NSCC is proposing to introduce the concept of an “Event Period” to the Rules to address the losses and liabilities that may arise from or relate to multiple Defaulting Member Events

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<sup>14</sup> See Resilience of central counterparties (CCPs): Further guidance on the PFMI, issued by the Committee on Payments and Market Infrastructures and the International Organization of Securities Commissions, at 42 (July 2017), available at [www.bis.org/cpmi/publ/d163.pdf](http://www.bis.org/cpmi/publ/d163.pdf).

and/or Declared Non-Default Loss Events that arise in quick succession. Specifically, the proposal would group Defaulting Member Events and Declared Non-Default Loss Events occurring in a period of ten (10) business days (“Event Period”) for purposes of allocating losses to Members in one or more rounds (as described below), subject to the limitations of loss allocation set forth in the proposed rule change and as explained below.<sup>15</sup> In the case of a loss or liability arising from or relating to a Defaulting Member Event, an Event Period would begin on the day NSCC notifies Members that it has ceased to act<sup>16</sup> for the Defaulting Member (or the next business day, if such day is not a business day). In the case of a loss or liability arising from or relating to a Declared Non-Default Loss Event, an Event Period would begin on the day that NSCC notifies Members of the Declared Non-Default Loss Event (or the next business day, if such day is not a business day). If a subsequent Defaulting Member Event or Declared Non-Default Loss Event occurs during an Event Period, any losses or liabilities arising out of or relating to any such subsequent event would be resolved as losses or liabilities that are part of the same Event Period, without extending the duration of such Event Period. An Event Period may include both Defaulting Member Events and Declared Non-Default Loss Events, and there would not be separate Event Periods for Defaulting Member Events or Declared Non-Default Loss Events occurring during overlapping ten (10) business day periods.

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<sup>15</sup> NSCC believes that having a ten (10) business day Event Period would provide a reasonable period of time to encompass potential sequential Defaulting Member Events or Declared Non-Default Loss Events that are likely to be closely linked to an initial event and/or a severe market dislocation episode, while still providing appropriate certainty for Members concerning their maximum exposure to mutualized losses with respect to such events.

<sup>16</sup> Supra note 7.

The amount of losses that may be allocated by NSCC, subject to the required Corporate Contribution, and to which a Loss Allocation Cap would apply for any Member that elects to withdraw from membership in respect of a loss allocation round, would include any and all losses from any Defaulting Member Events and any Declared Non-Default Loss Events during the Event Period, regardless of the amount of time, during or after the Event Period, required for such losses to be crystallized and allocated.<sup>17</sup>

The proposed rule changes relating to the implementation of an Event Period are set forth in proposed Section 4 of Rule 4, as further described below.

(3) Introducing the concept of “rounds” and Loss Allocation Notice.

Pursuant to the proposed rule change, a loss allocation “round” would mean a series of loss allocations relating to an Event Period, the aggregate amount of which is limited by the sum of the Loss Allocation Caps of affected Members (a “round cap”). When the aggregate amount of losses allocated in a round equals the round cap, any additional losses relating to the applicable Event Period would be allocated in one or more subsequent rounds, in each case subject to a round cap for that round. NSCC may continue the loss allocation process in successive rounds until all losses from the Event Period are allocated among Members that have not submitted a Loss Allocation Withdrawal Notice in accordance with proposed Section 6 of Rule 4.

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<sup>17</sup> As discussed below, each Member that is a Member on the first day of an Event Period would be obligated to pay its pro rata share of losses and liabilities arising out of or relating to each Defaulting Member Event (other than a Defaulting Member Event with respect to which it is the Defaulting Member) and each Declared Non-Default Loss Event occurring during the Event Period.

Each loss allocation would be communicated to Members by the issuance of a notice that advises the Members of the amount being allocated to them (“Loss Allocation Notice”). Each Member’s pro rata share of losses and liabilities to be allocated in any round would be equal to (i) the average of its Required Fund Deposit for the seventy (70) business days preceding the first day of the applicable Event Period or such shorter period of time that the Member has been a Member (each Member’s “Average RFD”), divided by (ii) the sum of Average RFD amounts of all Members subject to loss allocation in such round.

Each Loss Allocation Notice would specify the relevant Event Period and the round to which it relates. The first Loss Allocation Notice in any first, second, or subsequent round would expressly state that such Loss Allocation Notice reflects the beginning of the first, second, or subsequent round, as the case may be, and that each Member in that round has five (5) business days from the issuance of such first Loss Allocation Notice for the round to notify NSCC of its election to withdraw from membership with NSCC pursuant to proposed Section 6 of Rule 4, and thereby benefit from its Loss Allocation Cap.<sup>18</sup> The “Loss Allocation Cap” of a Member would be equal to the greater of (x) its Required Fund Deposit on the first day of the applicable Event Period and (y) its Average RFD.

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<sup>18</sup> Pursuant to the current Section 8 of Rule 4, the time period for a participant to give notice of its election to terminate its business with NSCC in respect of a pro rata charge is ten (10) business days after receiving notice of a pro rata charge. Supra note 5.

NSCC believes that it is appropriate to shorten such time period from ten (10) business days to five (5) business days because NSCC needs timely notice of which Members would remain in its membership for purposes of calculating the loss allocation for any subsequent round. NSCC believes that five (5) business

After a first round of loss allocations with respect to an Event Period, only Members that have not submitted a Loss Allocation Withdrawal Notice in accordance with proposed Section 6 of Rule 4 would be subject to further loss allocation with respect to that Event Period.

The amount of any second or subsequent round cap may differ from the first or preceding round cap because there may be fewer Members in a second or subsequent round if Members elect to withdraw from membership with NSCC as provided in proposed Section 6 of Rule 4 following the first Loss Allocation Notice in any round.

For example, for illustrative purposes only, after the required Corporate Contribution, if NSCC has a \$5 billion loss determined with respect to an Event Period and the sum of Loss Allocation Caps for all Members subject to the loss allocation is \$4 billion, the first round would begin when NSCC issues the first Loss Allocation Notice for that Event Period. NSCC could issue one or more Loss Allocation Notices for the first round until the sum of losses allocated equals \$4 billion. Once the \$4 billion is allocated, the first round would end and NSCC would need a second round in order to allocate the remaining \$1 billion of loss. NSCC would then issue a Loss Allocation Notice for the \$1 billion and this notice would be the first Loss Allocation Notice for the second round. The issuance of the Loss Allocation Notice for the \$1 billion would begin the second round.

The proposed rule change would link the Loss Allocation Cap to a round in order to provide Members the option to limit their loss allocation exposure at the beginning of each round. As proposed and as described further below, a Member could limit its loss

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days would provide Members with sufficient time to decide whether to cap their loss allocation obligations by withdrawing from their membership in NSCC.



allocation exposure to its Loss Allocation Cap by providing notice of its election to withdraw from membership within five (5) business days after the issuance of the first Loss Allocation Notice in any round.

The proposed rule changes relating to the implementation of “rounds” and Loss Allocation Notices are set forth in proposed Section 4 of Rule 4, as further described below.

- (4) Implementing a “look-back” period to calculate a Member’s loss allocation pro rata share and its Loss Allocation Cap.

Currently, the Rules calculate a Member’s pro rata share for purposes of loss allocation based on the Member’s “allocation for a System,” which in turn is based on settlement dollar amounts. Therefore, a Member’s loss allocation obligations are currently based on the Member’s activity in each of the various services or “Systems” offered by NSCC.<sup>19</sup> The Rules do not anticipate the possibility of more than one Defaulting Member Event or Declared Non-Default Loss Event in quick succession.

Given NSCC’s risk-based margining methodology, NSCC believes that it would be more appropriate to determine a Member’s pro rata share of losses and liabilities based on the amount of risk that the Member brings to NSCC, which is represented by the Member’s Required Deposit (NSCC is proposing that “Required Deposits” be renamed “Required Fund Deposits,” as described below). Accordingly, NSCC is proposing to calculate each Member’s pro rata share of losses and liabilities to be allocated in any round (as described above and in the proposed rule change) to be equal to (i) the

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<sup>19</sup> NSCC’s current loss allocation rules pre-date NSCC’s move to a risk-based margining methodology.

Member's Average RFD divided by (ii) the sum of Average RFD amounts for all Members that are subject to loss allocation in such round.

Additionally, as described above and in the proposed rule change, if a Member withdraws from membership pursuant to proposed Section 6 of Rule 4, NSCC is proposing that the Member's Loss Allocation Cap be equal to the greater of (i) its Required Fund Deposit on the first day of the applicable Event Period or (ii) its Average RFD.

NSCC believes that employing a backward-looking average to calculate a Member's loss allocation pro rata share and Loss Allocation Cap would disincentivize Member behavior that could heighten volatility or reduce liquidity in markets in the midst of a financial crisis. Specifically, the proposed look-back period would discourage a Member from reducing its settlement activity during a time of stress primarily to limit its loss allocation pro rata share, which, as proposed, would now be based on the Member's average settlement activity over the look-back period rather than its settlement activity at a point in time that the Member may not be able to estimate. Similarly, NSCC believes that taking a backward-looking average into consideration when determining a Member's Loss Allocation Cap would also deter a Member from reducing its settlement activity during a time of stress primarily to limit its Loss Allocation Cap.

NSCC believes that having a look-back period of seventy (70) business days is appropriate, because it would be long enough to enable NSCC to capture a full calendar quarter of a Member's activities, including quarterly option expirations, and smooth out the impact from any abnormalities and/or arbitrariness that may have occurred, but not

too long that the Member's business strategy and outlook could have shifted significantly, resulting in material changes to the size of its portfolios.

The proposed rule changes relating to the implementation of a look-back period are set forth in proposed Section 4 of Rule 4, as further described below.

(5) Capping withdrawing Members' loss allocation exposure and related changes.

NSCC's current loss allocation rules allow a Member to withdraw if the Member notifies NSCC, within ten (10) business days after receipt of notice of a pro rata charge, of its election to terminate its membership and thereby avail itself of a cap on loss allocation, which is its Required Deposit as fixed immediately prior to the time of the pro rata charge. As discussed above, the proposed rule change would continue providing Members the opportunity to limit their loss allocation exposure by offering withdrawal options; however, the cap on loss allocation would be calculated differently and the associated withdrawal process would also be modified as it relates to withdrawals associated with the loss allocation process. In particular, the proposed rule change would shorten the withdrawal notification period from ten (10) business days to five (5) business days, and would also change the beginning of such notification period from the receipt of the notice of a pro rata charge to the issuance of the notice, as further described below. As proposed, if a Member timely provides notice of its withdrawal from membership in respect of a loss allocation round, the maximum amount of losses it would be responsible for would be its Loss Allocation Cap,<sup>20</sup> provided that the Member

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<sup>20</sup> If a Member's Loss Allocation Cap exceeds the Member's then-current Required Fund Deposit, it must still cover the excess amount.

complies with the requirements of the withdrawal process in proposed Section 6 of Rule 4.<sup>21</sup>

Currently, NSCC's loss allocation provisions provide that if a pro rata charge is made against a Member's actual Clearing Fund deposit, and as result thereof the Member's deposit is less than its Required Deposit, the Member will, upon demand by NSCC, be required to replenish its deposit to eliminate the deficiency within such time as NSCC shall require. To increase transparency of the timeframe under which NSCC would require funds from Members to satisfy their loss allocation obligations, NSCC is proposing that Members would receive two (2) business days' notice of a loss allocation, and Members would be required to pay the requisite amount no later than the second business day following issuance of such notice.<sup>22</sup> Members would have five (5) business days<sup>23</sup> from the issuance of the first Loss Allocation Notice in any round of an Event Period to decide whether to withdraw from membership.<sup>24</sup>

Each round would allow a Member the opportunity to notify NSCC of its election to withdraw from membership after satisfaction of the losses allocated in such round.

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<sup>21</sup> For the avoidance of doubt, pursuant to Section 13(d) of Rule 4(A) (Supplemental Liquidity Deposits), a Special Activity Supplemental Deposit of a Member may not be used to calculate or be applied to satisfy any pro rata charge pursuant to Section 4 of Rule 4. Supra note 5.

<sup>22</sup> NSCC believes that allowing Members two (2) business days to satisfy their loss allocation obligations would provide Members sufficient notice to arrange funding, if necessary, while allowing NSCC to address losses in a timely manner.

<sup>23</sup> Supra note 18.

<sup>24</sup> NSCC believes that setting the start date of the withdrawal notification period to the date of issuance of a notice would provide a single withdrawal timeframe that would be consistent across the Members.

Multiple Loss Allocation Notices may be issued with respect to each round to allocate losses up to the round cap.

Specifically, the first round and each subsequent round of loss allocation would allocate losses up to a round cap of the aggregate of all Loss Allocation Caps of those Members included in the round. If a Member provides notice of its election to withdraw from membership, it would be subject to loss allocation in that round, up to its Loss Allocation Cap. If the first round of loss allocation does not fully cover NSCC's losses, a second round will be noticed to those Members that did not elect to withdraw from membership in the previous round; however, as noted above, the amount of any second or subsequent round cap may differ from the first or preceding round cap because there may be fewer Members in a second or subsequent round if Members elect to withdraw from membership with NSCC as provided in proposed Section 6 of Rule 4 following the first Loss Allocation Notice in any round.

Pursuant to the proposed rule change, in order to avail itself of its Loss Allocation Cap, a Member would need to follow the requirements in proposed Section 6 of Rule 4, which would provide that the Member must: (i) specify in its Loss Allocation Withdrawal Notice (as defined below and in the proposed rule change) an effective date of withdrawal, which date shall be no later than ten (10) business days following the last day of the applicable Loss Allocation Withdrawal Notification Period (as defined below and in the proposed rule change) (i.e., no later than ten (10) business days after the 5th business day following the first Loss Allocation Notice in that round of loss allocation),<sup>25</sup>

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<sup>25</sup> NSCC believes that having an effective date of withdrawal that is not later than ten (10) business days following the last day of the Loss Allocation Withdrawal Notification Period would provide Members with a reasonable period of time to

(ii) cease all activity that would result in transactions being submitted to NSCC for clearance and settlement for which such Member would be obligated to perform, where the scheduled final settlement date would be later than the effective date of the Member's withdrawal, and (iii) ensure that all clearance and settlement activity for which such Member is obligated to NSCC is fully and finally settled by the effective date of the Member's withdrawal, including, without limitation, by resolving by such date all fails and buy-in obligations.

As proposed, a Member that withdraws in compliance with proposed Section 6 of Rule 4 would remain obligated for its pro rata share of losses and liabilities with respect to any Event Period for which it is otherwise obligated under Rule 4; however, its aggregate obligation would be limited to the amount of its Loss Allocation Cap (as fixed in the round for which it withdrew).

The proposed rule changes are designed to enable NSCC to continue the loss allocation process in successive rounds until all of NSCC's losses are allocated. To the extent that a Member's Loss Allocation Cap exceeds the Member's Required Fund Deposit on the first day of the applicable Event Period, NSCC may in its discretion retain any excess amounts on deposit from the Member, up to the Member's Loss Allocation Cap.

The proposed rule changes relating to capping withdrawing Members' loss allocation exposure and related changes to the withdrawal process are set forth in proposed Sections 4 and 6 of Rule 4, as further described below.

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wind down their activities at NSCC while minimizing any uncertainty typically associated with a longer withdrawal period.

## B. Changes to Align Loss Allocation Rules

The proposed rule changes would align the loss allocation rules, to the extent practicable and appropriate, of the three DTCC Clearing Agencies so as to provide consistent treatment, especially for firms that are participants of two or more DTCC Clearing Agencies. As proposed, the loss allocation waterfall and certain related provisions, e.g., returning a former Member's Clearing Fund, would be consistent across the DTCC Clearing Agencies to the extent practicable and appropriate. The proposed rule changes of NSCC that would align loss allocation rules of the DTCC Clearing Agencies are set forth in proposed Sections 1, 2, 7, and 12 of Rule 4, as further described below.

## C. Clarifying Changes Relating to Loss Allocation

The proposed rule changes are intended to make the provisions in the Rules governing loss allocation more transparent and accessible to Members. In particular, NSCC is proposing the following changes relating to loss allocation to clarify Members' obligations for Declared Non-Default Loss Events.

Aside from losses that NSCC might face as a result of a Defaulting Member Event, NSCC could incur non-default losses incident to its clearance and settlement business.<sup>26</sup> The Rules currently permit NSCC to apply Clearing Fund to non-default losses. Specifically, pursuant to Section 2(b) of Rule 4,<sup>27</sup> NSCC can use the Clearing Fund to satisfy losses or liabilities of NSCC incident to the operation of the clearance and

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<sup>26</sup> Non-default losses may arise from events such as damage to physical assets, a cyber-attack, or custody and investment losses.

<sup>27</sup> Section 2(b) of Rule 4 provides that "the use of the Clearing Fund...shall be limited to satisfaction of losses or liabilities of the Corporation incident to the operation of the clearance and settlement business of the Corporation other than losses and liabilities of a System." Supra note 5.

settlement business of NSCC. Section II of Addendum K provides additional details regarding the application of the Clearing Fund to losses outside of a System.

If there is a failure of NSCC following a non-default loss, such occurrence would affect Members in much the same way as a failure of NSCC following a Defaulting Member Event. Accordingly, NSCC is proposing rule changes to enhance the provisions relating to non-default losses by clarifying Members' obligations for such losses.

Specifically, NSCC is proposing enhancement of the governance around non-default losses that would trigger loss allocation to Members by specifying that the Board of Directors would have to determine that there is a non-default loss that may be a significant and substantial loss or liability that may materially impair the ability of NSCC to provide clearance and settlement services in an orderly manner and will potentially generate losses to be mutualized among the Members in order to ensure that NSCC may continue to offer clearance and settlement services in an orderly manner. The proposed rule change would provide that NSCC would then be required to promptly notify Members of this determination, which is referred to in the proposed rule as a Declared Non-Default Loss Event. In addition, NSCC is proposing to better align the interests of NSCC with those of its Members by stipulating a mandatory Corporate Contribution apply to a Declared Non-Default Loss Event prior to any allocation of the loss among Members, as described above. Additionally, NSCC is proposing language to clarify Members' obligations for Declared Non-Default Loss Events.

The proposed rule changes relating to Declared Non-Default Loss Events and Members' obligations for such events are set forth in proposed Section 4 of Rule 4, as further described below.



**D. Reduce the time within which NSCC is required to return a former Member's Clearing Fund deposit**

The proposed rule change would reduce the time period in which NSCC may retain a Member's Clearing Fund deposit. Specifically, NSCC proposes that if a Member gives notice to NSCC of its election to withdraw from membership, NSCC will return the Member's Actual Deposit in the form of (i) cash or securities within thirty (30) calendar days and (ii) Eligible Letters of Credit within ninety (90) calendar days, after all of the Member's transactions have settled and all matured and contingent obligations to NSCC for which the Member was responsible while a Member have been satisfied, except NSCC may retain for up to two (2) years the Actual Deposits from Members who have Sponsored Accounts at DTC.

NSCC believes that shortening the time period for the return of a Member's Clearing Fund deposit would be helpful to firms who have exited NSCC so that they could have use of the deposits sooner than under the current Rules while at the same time protecting NSCC because such return would only occur if all obligations of the terminating Member to NSCC have been satisfied, which would include both matured as well as contingent obligations.

The proposed rule changes relating to the reduced time period in which NSCC is required to return the Clearing Fund deposit of a former Member are set forth in proposed Section 7 of Rule 4, as further described below.

The foregoing changes as well as other changes (including a number of conforming and technical changes) that NSCC is proposing in order to improve the transparency and accessibility of the Rules are described in detail below.

#### E. Loss Allocation Waterfall Comparison

The following example<sup>28</sup> illustrates the differences between the current and proposed loss allocation provisions:

##### Assumptions:

- (i) Member A defaults on a business day (Day 1). On the same day, NSCC ceases to act for Member A and notifies Members of the cease to act. After liquidating Member A's portfolio and applying Member A's Clearing Fund deposit, NSCC has a loss of \$350 million.
- (ii) Member X voluntarily retires from membership five (5) business days after NSCC ceases to act for Member A (Day 6).
- (iii) Member B defaults seven (7) business days after NSCC ceases to act for Member A (Day 8). On the same day, NSCC ceases to act for Member B and notifies Members of the cease to act. After liquidating Member B's portfolio and applying Member B's Clearing Fund deposit, NSCC has a loss of \$350 million.
- (iv) The current NSCC loss provisions require NSCC to contribute no less than 25% of its retained earnings as a corporate contribution.

For the purposes of this example, it is assumed that NSCC will

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<sup>28</sup> For purposes of this example, NSCC has assumed that the losses occurred with guaranteed CNS activity of Members, and NSCC allocated all such Members' deposits to the Clearing Fund to CNS activity (which is typically more than 99% of the NSCC daily gross settlement amount).

contribute 25% of its retained earnings. The amount of NSCC's retained earnings is \$416 million.

- (v) NSCC's General Business Risk Capital Requirement is \$154 million.

Current Loss Allocation:

Under the current loss allocation provisions, with respect to the losses arising out of Member A's default, NSCC will contribute \$104 million ( $\$416 \text{ million} * 25\%$ ) from retained earnings and then allocate the remaining loss of \$246 million ( $\$350 \text{ million} - \$104 \text{ million}$ ) to Members.

With respect to losses arising out of Member B's default, NSCC will contribute \$78 million ( $(\$416 \text{ million} - \$104 \text{ million}) * 25\%$ ) from retained earnings and then allocate the remaining loss of \$272 million ( $\$350 \text{ million} - \$78 \text{ million}$ ) to Members. Because Member X voluntarily retired before NSCC ceased to act for Member B, Member X is not subject to loss allocation with respect to losses arising out of Member B's default.

Altogether, with respect to losses arising out of defaults of Member A and Member B, NSCC will contribute \$182 million of retained earnings and will allocate losses of \$518 million to Members.

Proposed Loss Allocation:

Under the proposed loss allocation provisions, a Defaulting Member Event with respect to Member A's default would have occurred on Day One, and a Defaulting Member Event with respect to Member B's default would have occurred on Day 8. Because the Defaulting Member Events occurred during a 10-business day period, they

would be grouped together into an Event Period for purposes of allocating losses to Members. The Event Period would begin on the 1<sup>st</sup> business day and end on the 10<sup>th</sup> business day.

With respect to losses arising out of Member A's default, NSCC would apply a Corporate Contribution of \$77 million ( $\$154 \text{ million} * 50\%$ ) and then allocate the remaining loss of \$273 million ( $\$350 \text{ million} - \$77 \text{ million}$ ) to Members. With respect to losses arising out of Member B's default, NSCC would not apply a Corporate Contribution since it would have already contributed the maximum Corporate Contribution of 50% of its General Business Risk Capital Requirement. NSCC would allocate the losses of \$350 million arising out of Member B's default to Members. Because Member X was a Member on the first day of the Event Period, Member X would be subject to loss allocation with respect to all events occurring during the Event Period, even if the event occurred after its retirement. Therefore, Member X would be subject to loss allocation with respect to Member B's default.

Altogether, with respect to losses arising out of defaults of Member A and Member B, NSCC would apply a Corporate Contribution of \$77 million and would allocate losses of \$623 million to Members. The principal differences in the above example are due to (i) the proposed changes to the calculation and application of the Corporate Contribution and (ii) the proposed introduction of an Event Period.

(ii) Detailed Description of the Proposed Rule Changes Related to Loss Allocation

A. Proposed Changes to Rule 4 (Clearing Fund)

Overview of Rule 4 (Clearing Fund)

Rule 4 currently addresses Clearing Fund requirements and loss allocation obligations. While Procedure XV addresses the various Clearing Fund calculations, Rule 4 sets forth rights, obligations and other aspects associated with the Clearing Fund, as well as the loss allocation process. Rule 4 is currently organized into 12 sections. NSCC is proposing changes to each section, and consolidating provisions in Rule 4 relating to Mutual Fund Services and Insurance and Retirement Processing Services into new sections, as described below.

Section 1

Section 1 of Rule 4 currently sets forth the requirement that each Member and Mutual Fund/Insurance Services Member shall, and each Fund Member and Insurance Carrier/Retirement Services Member may, be required to make a deposit to the Clearing Fund. Section 1 currently provides that each participant's Required Deposit is based on one or more formulas specified by NSCC's Board of Directors. The basis of each such formula is participants' usage of NSCC's facilities. Section 1 also currently sets forth the minimum amount of each participant category's Required Deposit.

Current Section 1 allows a portion of a participant's Clearing Fund deposit to be evidenced by an open account indebtedness secured by Eligible Clearing Fund Securities, subject to certain limitations set forth in Procedure XV, and sets forth the various requirements associated with the deposit of Eligible Clearing Fund Securities. Current

Section 1 also permits NSCC to require participants to post a letter of credit where NSCC believes the participants present legal risk.

Current Section 1 also provides that NSCC allocate the Clearing Fund by types of service (e.g., Mutual Fund Services) as well as by Systems (e.g., CNS), and divide the Clearing Fund into separate “Allocations” for each such service and separate “Funds” for each such System.

Under the proposed rule change, NSCC is proposing to add a subheading of “Required Fund Deposits” to Section 1 and restructure Section 1 so that it applies to Members only and delete references to Mutual Fund/Insurance Services Members, Fund Members and Insurance Carrier/Retirement Services Members from Section 1.<sup>29</sup> Provisions of Rule 4 regarding Mutual Fund/Insurance Services Members and Fund Members would be covered in a new proposed Section 13 to Rule 4, discussed below. Provisions of Rule 4 regarding Insurance Carrier/Retirement Services Members would be covered in a new proposed Section 14 to Rule 4, discussed below.

Under the proposed rule change, Section 1 would continue to have the same provisions as they relate to Members except for the following: (i) the language throughout the section would be reorganized, streamlined and clarified, (ii) “Required Deposits” would be renamed “Required Fund Deposits,”<sup>30</sup> which is a more descriptive term to refer to Members’ deposits required for the Clearing Fund, and would harmonize

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<sup>29</sup> In addition to Section 1 of Rule 4, NSCC is proposing to delete references to Mutual Fund/Insurance Services Members, Fund Members and Insurance Carrier/Retirement Services Members from Sections 2, 3, 4, 5, 6, 7, 8, 9, and 12 of Rule 4.

<sup>30</sup> In addition to Section 1 of Rule 4, NSCC is proposing to rename “Required Deposits” to “Required Fund Deposits” in Sections 2, 3, 4, 8, 9, and 11 of Rule 4.

with the rules of FICC/GSD and FICC/MBSD<sup>31</sup> and the term used in such rules,<sup>32</sup> (iii) a sentence would be added regarding additional deposits maintained by the Members at NSCC, (iv) the provision regarding the Clearing Fund being allocated by Systems and services would be deleted,<sup>33</sup> and (v) change “Rules” to “Rules and Procedures” to better reflect the name of NSCC’s rulebook.<sup>34</sup>

The proposed sentence regarding additional deposits to the Clearing Fund would permit Members to post such additional deposits at their discretion and would make clear that such additional deposits would be deemed to be part of the Clearing Fund and the Member’s Actual Deposit (as discussed below and as defined in the proposed rule change) but would not be deemed to be part of the Member’s Required Fund Deposit.

NSCC proposes to add language in Section 1 to make it clear that each Member would grant NSCC a first priority perfected security interest in its right, title and interest in and to any Eligible Clearing Fund Securities, funds and assets pledged to NSCC to secure the Member’s open account indebtedness or placed by the Member in NSCC’s possession (or its agents acting on its behalf) to secure all such Member’s obligations to NSCC, and that NSCC would be entitled to exercise the rights of a pledgee under

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<sup>31</sup> FICC/GSD Rulebook (“FICC/GSD Rules”), available at [http://dtcc.com/~media/Files/Downloads/legal/rules/ficc\\_gov\\_rules.pdf](http://dtcc.com/~media/Files/Downloads/legal/rules/ficc_gov_rules.pdf) and FICC/MBSD Clearing Rules (“FICC/MBSD Rules”), available at [http://dtcc.com/~media/Files/Downloads/legal/rules/ficc\\_mbsd\\_rules.pdf](http://dtcc.com/~media/Files/Downloads/legal/rules/ficc_mbsd_rules.pdf).

<sup>32</sup> See FICC/GSD Rule 1 (Definitions) and FICC/MBSD Rule 1 (Definitions), supra note 31.

<sup>33</sup> In addition to Section 1 of Rule 4, NSCC is proposing to delete references to the Clearing Fund being allocated by Systems and services from Sections 2, 3, and 4 of Rule 4.

<sup>34</sup> In addition to Section 1 of Rule 4, NSCC is proposing to change “Rules” to “Rules and Procedures” in Sections 9 and 12 of Rule 4.

common law and a secured party under Articles 8 and 9 of the New York Uniform Commercial Code with respect to such assets. The additional language would further harmonize the Rules with language used in the FICC/GSD Rules and FICC/MBSD Rules,<sup>35</sup> thus providing consistent treatment of pledged resources for firms that are members of both NSCC and FICC.

NSCC proposes to clarify the language in footnote 2 of Section 1. In addition, NSCC proposes to add “Eligible Letter of Credit” as a defined term to refer to letters of credit posted by participants if required by NSCC,<sup>36</sup> which would harmonize the term with the term used in the FICC/GSD Rules and FICC/MBSD Rules,<sup>37</sup> thus providing consistent terminology for firms that are members of both NSCC and FICC.

Similarly, NSCC proposes to add “Actual Deposit” as a defined term in Section 1 to refer to Eligible Clearing Fund Securities, funds and assets pledged to NSCC to secure a Member’s open account indebtedness or placed by a Member in the possession of NSCC (or its agents acting on its behalf) and any Eligible Letters of Credit issued on behalf of a Member in favor of NSCC.

Instead of requiring participants to pledge Eligible Clearing Fund Securities to NSCC’s account at a Qualified Securities Depository designated by the participants, NSCC proposes to clarify and streamline Section 1 of proposed Rule 4 to provide that

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<sup>35</sup> See Section 4 of FICC/GSD Rule 4 and Section 4 of FICC/MBSD Rule 4, supra note 31.

<sup>36</sup> In addition to Section 1 of Rule 4, NSCC is also proposing to rename “Letter of Credit” to “Eligible Letter of Credit” in Sections 2 and 12 of Rule 4.

<sup>37</sup> See FICC/GSD Rule 1 (Definitions) and FICC/MBSD Rule 1 (Definitions), supra note 31.



Eligible Clearing Fund Securities pledged to secure a Member's open account indebtedness would be delivered to NSCC's account at DTC.

NSCC would delete the provision regarding allocation of the Clearing Fund by Systems and services, as this provision is no longer relevant under the proposed rule change. Provisions relating to Mutual Fund Services and Insurance and Retirement Processing Services in Section 1 (as well as other sections in Rule 4) would be consolidated in the proposed new Sections 13 and 14, entitled "Mutual Fund Deposits" and "Insurance Deposits," respectively.

To consolidate provisions regarding the maintenance, investment and permitted use of Clearing Fund, NSCC would move the last paragraph of Section 1 about segregation and maintenance of Clearing Fund (again, in terms of "Fund," "System," and "Allocation," as discussed above) to Section 2.

In addition, NSCC proposes to correct a typographical error in the reference to a footnote in Section 1 of Rule 4. Specifically, there is an incorrect reference to footnote 22 in the second paragraph of Section 1 in current Rule 4. NSCC is proposing to change this reference to reflect the correct footnote, which is footnote 2.

#### Section 2

Section 2 of Rule 4 currently covers the permitted uses of the Clearing Fund (again by "Fund" and "Allocation," as set forth in current Section 1), including the investment of Clearing Fund Cash and Cash Receipts, as well as participants' rights to any interest earned or paid on pledged Eligible Clearing Fund Securities or cash deposits.

NSCC is proposing to add a subheading of "Permitted Use, Investment, and Maintenance of Clearing Fund Assets" to Section 2 and restructure Section 2 so that it applies to Members only. NSCC is also proposing to restructure Section 2 so that the

permitted use of Clearing Fund appears first, then the investment of Clearing Fund, followed by maintenance of Clearing Fund.

Under the proposed rule change, the permitted use of Clearing Fund paragraph would continue to have the same provisions as they relate to how the Clearing Fund can be used by NSCC, except the provisions would be streamlined and clarified. Specifically, in order to be consistent with the proposed change in Section 4 (as described below) regarding NSCC requiring Members to pay their loss allocation amounts (leaving their Required Fund Deposits intact), NSCC is proposing to modify the permitted use of Clearing Fund to make it clear that the Clearing Fund can be used by NSCC to secure each Member's performance of obligations to NSCC, including each Member's obligations with respect to any loss allocations as set forth in Section 4 of Rule 4. NSCC is also proposing to delete the defined term of Cash Receipts and related provisions from Rule 4 because, unlike the Clearing Fund, Cash Receipts are money payments received from participants and payable to others; therefore, NSCC believes that continuing to include Cash Receipts in Rule 4 is no longer necessary and may cause confusion among Members.

NSCC is proposing to add a paragraph that provides that each time NSCC uses any part of the Clearing Fund to provide liquidity to NSCC to meet its settlement obligations, including, without limitation, through the direct use of cash in the Clearing Fund or through the pledge or rehypothecation of pledged Eligible Clearing Fund Securities in order to secure liquidity for more than thirty (30) calendar days, NSCC, at the close of business on the 30<sup>th</sup> calendar day (or on the first business day thereafter) from the day of such use, would consider the amount used but not yet repaid as a loss to

the Clearing Fund incurred as a result of a Defaulting Member Event and immediately allocate such loss in accordance with proposed Section 4 of Rule 4. NSCC believes that this proposed change would increase transparency and accessibility of the Rules for Members by specifying a point in time by which NSCC would need to replenish the Clearing Fund through loss allocation if NSCC uses the Clearing Fund to provide or secure liquidity to NSCC to meet its settlement obligations. NSCC believes that a period of thirty (30) calendar days would be appropriate because it would provide sufficient time for NSCC to determine whether it would be able to obtain the necessary funds from liquidation of the portfolio of the Defaulting Member to repay the used Clearing Fund amount. In addition, this proposed change would also harmonize this section with the comparable section in the FICC/GSD Rules and FICC/MBSD Rules,<sup>38</sup> so as to provide consistent treatment for firms that are members of both NSCC and FICC.

Proposed Section 2 would continue to have the same provisions concerning the investment and maintenance of the Clearing Fund, except these provisions would also be streamlined and clarified. Specifically, NSCC is proposing language to make it clear that it may invest cash in the Clearing Fund in accordance with the Clearing Agency Investment Policy adopted by NSCC.<sup>39</sup> NSCC would revise the relocated sentence from

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<sup>38</sup> See Section 5 of FICC/GSD Rule 4 and Section 5 of FICC/MBSD Rule 4, supra note 31.

<sup>39</sup> See Securities Exchange Act Release No. 79528 (December 12, 2016), 81 FR 91232 (December 16, 2016) (SR-NSCC-2016-003). The Clearing Agency Investment Policy (the “Policy”) governs the management, custody, and investment of cash deposited to the Clearing Fund, the proprietary liquid net assets (cash and cash equivalents) of NSCC and other funds held by NSCC. The Policy sets forth guiding principles for the investment of those funds, which include adherence to a conservative investment philosophy that places the highest priority on maximizing liquidity and avoiding risk, as well as mandating the segregation and separation of funds. The Policy also addresses the process for

Section 1 which provides that NSCC shall not be required to segregate any Clearing Fund (again, in terms of “Fund,” “System,” and “Allocation,” as discussed above) in order to (i) conform to the proposed deletions in Section 1 and use the newly defined term of “Actual Deposit” as set forth in Section 1 and (ii) make clear that NSCC would not be required to segregate a Member’s Actual Deposit but that NSCC would maintain books and records concerning the assets that constitute each Member’s Actual Deposit.

Under the proposed rule change, Members would continue to be entitled to any interest earned or paid on Clearing Fund cash deposits and pledged Eligible Clearing Fund Securities; however, NSCC is proposing additional language to make it clear that interest on pledged Eligible Clearing Fund Securities that is received by NSCC would be credited to a Member’s cash deposits to the Clearing Fund, except in the event of a default by such Member on any obligations to NSCC, in which case NSCC may exercise its rights under proposed Section 3 of Rule 4.

### Section 3

Section 3 of Rule 4 currently provides that NSCC may apply a participant’s actual deposit to any obligation the participant has to NSCC that the participant has failed to satisfy and to any Cross-Guaranty Obligation. Participants are required to eliminate any resulting deficiencies in their Required Deposits within such time as NSCC requires.

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evaluating credit ratings of counterparties and identifies permitted investments within specified parameters. In general, assets are required to be held by regulated and creditworthy financial institution counterparties and invested in financial instruments that, with respect to the Clearing Fund, may include deposits with banks, including the Federal Reserve Bank of New York, collateralized reverse-repurchase agreements, direct obligations of the U.S. government and money-market mutual funds.

Section 3 also currently provides for the manner in which loss allocation would apply with respect to Off-the-Market Transactions.

Under the proposed rule change, NSCC is proposing to add a subheading of “Application of Clearing Fund Deposits and Other Amounts to Members’ Obligations” and to delete provisions that do not apply to Members and/or that reference the Clearing Fund being allocated into Funds/Allocations by Systems and services. Under the proposed rule change, NSCC would retain the provisions in Section 3 regarding applying the Member’s Actual Deposit to satisfy an obligation to NSCC that a Member fails to satisfy and the requirement to replenish the Required Fund Deposit as necessary, but NSCC proposes to add clarifying language that, in addition to a Member’s Actual Deposit, NSCC will also apply any amounts available under a Clearing Agency Cross-Guaranty Agreement and any proceeds therefrom to satisfy the obligation. NSCC also proposes to add language making it clear that NSCC may take any and all actions with respect to the assets and amounts referenced in the prior sentence, including assignment, transfer, and sale of any Eligible Clearing Fund Securities, that NSCC determines is appropriate.

Under the proposed rule change, NSCC would move the provision regarding allocation of losses from Off-the-Market Transactions to proposed Section 4 of Rule 4, which addresses allocation of losses to Members. NSCC would streamline and clarify the remaining provisions for transparency and accessibility.

#### Section 4 and Section 5

Current Section 4 of Rule 4 contains NSCC’s current loss allocation waterfall, which would be initiated if NSCC incurs a loss or liability in a System that is not satisfied

pursuant to current Section 3. Section 4 currently provides for the following loss allocation waterfall:

- (i) Application of NSCC's existing retained earnings or such lesser part<sup>40</sup> of the existing retained earnings unless the Board of Directors elects to apply the Fund/Allocation for a particular System or service.
- (ii) If a loss or liability remains after the application of the retained earnings, NSCC would apply the Clearing Fund (this application is subject to the current structure where the Rules provide that the Clearing Fund is allocated to different Systems/services).
  - a. NSCC is required to provide participants and the Commission with 5 business days' prior notice before applying the Clearing Fund.
  - b. Participants (other than those responsible for causing the loss or liability) would be charged pro rata based upon their allocation to the applicable Fund, less any amounts that participants were required to deposit pursuant to Rule 15.

Section 5 of Rule 4 currently states that if a pro rata charge is made pursuant to Rule 4 against a participant's actual Clearing Fund deposit, and as a consequence thereof the participant's remaining deposit is less than its Required Deposit, the participant would, upon demand by NSCC, be required to replenish its deposit to eliminate the deficiency within such time as NSCC shall require. Current Section 5 further provides that if the participant does not take this required action, NSCC may take disciplinary

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<sup>40</sup> Addendum E provides that NSCC "will apply no less than twenty-five percent (25%) of its retained earnings, existing at the time of a Member impairment which gives rise to a loss or liability not satisfied by the impaired Member's Clearing Fund deposit, to such loss or liability." Supra note 5.

action against the participant, and any disciplinary action taken against the participant or the voluntary or involuntary termination of the participant's membership will not affect the obligations of the participant to NSCC or any remedy to which NSCC may be entitled under applicable law.

Under the proposed rule change, NSCC is proposing to add a subheading of "Loss Allocation Waterfall, Off-the-Market Transactions" to Section 4 and delete provisions that do not apply to Members and/or that reference the Clearing Fund being allocated into Funds/Allocations by System or service. In addition, NSCC is proposing to restructure its loss allocation waterfall as described below.

Under the proposal, Section 4 would make clear that the loss allocation waterfall applies to any loss and liability incurred by NSCC arising out of or relating to a Defaulting Member Event or a Declared Non-Default Loss Event.

As proposed, Section 4 would provide that, for the purposes of Rule 4, the term "Defaulting Member" would mean a Member for which NSCC has ceased to act pursuant to Rule 46,<sup>41</sup> the term "Defaulting Member Event" would mean the determination by NSCC to cease to act for a Member pursuant to Rule 46, and the term "Declared Non-Default Loss Event" would mean the determination by the Board of Directors that a loss or liability incident to the clearance and settlement business of NSCC may be a significant and substantial loss or liability that may materially impair the ability of NSCC to provide clearance and settlement services in an orderly manner and will potentially generate losses to be mutualized among Members in order to ensure that NSCC may

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<sup>41</sup> NSCC may cease to act for a Member pursuant to any of the circumstances set forth under Rule 46 (Restrictions on Access to Services), including, but not limited to, in the event the Member is in default of any delivery of funds or securities to NSCC. Supra note 5.

continue to offer clearance and settlement services in an orderly manner. Proposed Section 4 would establish the concept of an “Event Period” to provide for a clear and transparent way of handling multiple loss events occurring in a period of ten (10) business days, which would be grouped into an Event Period.<sup>42</sup> As stated above, both Defaulting Member Events or Declared Non-Default Loss Events could occur within the same Event Period.

Under the proposal, an Event Period with respect to a Defaulting Member Event would begin on the day NSCC notifies participants that it has ceased to act for the Defaulting Member (or the next business day, if such day is not a business day). In the case of a Declared Non-Default Loss Event, an Event Period would begin on the day that NSCC notifies Members of the Declared Non-Default Loss Event (or the next business day, if such day is not a business day). If a subsequent Defaulting Member Event or Declared Non-Default Loss Event occurs during an Event Period, any losses or liabilities arising out of or relating to any such subsequent event would be resolved as losses or liabilities that are part of the same Event Period, without extending the duration of such Event Period.

As proposed, each Member would be obligated to NSCC for the entire amount of any loss or liability incurred by NSCC arising out of or relating to any Defaulting Member Event with respect to such Member. Under the proposal, to the extent that such loss or liability is not satisfied pursuant to proposed Section 3 of Rule 4, NSCC would apply a Corporate Contribution thereto and charge the remaining amount of such loss or liability ratably to other Members, as provided in proposed Section 4.

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<sup>42</sup> Supra note 15.



Under proposed Section 4, the loss allocation waterfall would begin with a corporate contribution from NSCC (“Corporate Contribution”), as is the case under the current Rules, but in a different form than under the current Section 4 of Rule 4. Today, pursuant to Addendum E, in the event of a Member impairment, NSCC is required to apply at least 25% of its retained earnings existing at the time of a Member impairment; however, no corporate contribution from NSCC is currently required for losses resulting other than those from Member impairments. Under the proposal, NSCC would amend Section 5 to add a subheading of “Corporate Contribution” and define NSCC’s Corporate Contribution with respect to any loss allocation pursuant to proposed Section 4 of Rule 4, whether arising out of or relating to a Defaulting Member Event or a Declared Non-Default Loss Event, as an amount that is equal to fifty (50) percent of the amount calculated by NSCC in respect of its General Business Risk Capital Requirement as of the end of the calendar quarter immediately preceding the Event Period.<sup>43</sup> The proposed rule change would specify that NSCC’s General Business Risk Capital Requirement, as defined in NSCC’s Clearing Agency Policy on Capital Requirements,<sup>44</sup> is, at a minimum, equal to the regulatory capital that NSCC is required to maintain in compliance with Rule 17Ad-22(e)(15) under the Act.<sup>45</sup>

As proposed, if NSCC applies the Corporate Contribution to a loss or liability arising out of or relating to one or more Defaulting Member Events or Declared Non-Default Loss Events relating to an Event Period, then for any subsequent Event Periods

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<sup>43</sup> Supra note 8.

<sup>44</sup> Supra note 9.

<sup>45</sup> Supra note 10.

that occur during the two hundred fifty (250) business days thereafter,<sup>46</sup> the Corporate Contribution would be reduced to the remaining unused portion of the Corporate Contribution amount that was applied for the first Event Period. Proposed Section 5 would require NSCC to notify Members of any such reduction to the Corporate Contribution.

Currently, the Rules do not require NSCC to contribute its retained earnings to losses and liabilities other than from Member impairments. Under the proposal, NSCC would expand the application of its corporate contribution beyond losses and liabilities from Member impairments. The proposed Corporate Contribution would apply to losses or liabilities relating to or arising out of Defaulting Member Events and Declared Non-Default Loss Events, and would be a mandatory loss contribution by NSCC prior to any allocation of the loss among Members.

Addendum E currently provides NSCC the option to contribute amounts higher than the specified percentage of retained earnings, as determined by the Board of Directors, to any loss or liability incurred by NSCC as the result of a Member's impairment. This option would be retained and expanded under the proposal to also cover non-default losses. Proposed Section 5 would provide that nothing in the Rules would prevent NSCC from voluntarily applying amounts greater than the Corporate Contribution against any NSCC loss or liability, whether arising out of or relating to a Defaulting Member Event or a Declared Non-Default Loss Event, if the Board of Directors, in its sole discretion, believes such to be appropriate under the factual situation existing at the time.

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<sup>46</sup> Supra note 13.

Proposed Section 4 of Rule 4 would provide that NSCC shall apply the Corporate Contribution to losses and liabilities that arise out of or relate to one or more Defaulting Member Events and/or Declared Non-Default Loss Events that occur within an Event Period. The proposed rule change also provides that if losses and liabilities with respect to such Event Period remain unsatisfied following application of the Corporate Contribution, NSCC would allocate such losses and liabilities to Members, as described below.

Proposed Section 4 of Rule 4 would also retain the requirement of loss allocation among Members if a loss or liability remains after the application of the Corporate Contribution, as described above. In contrast to the current Section 4 where NSCC would apply Members' Required Deposits to the mutualized loss allocation amounts, under the proposal, NSCC would require Members to pay their loss allocation amounts (leaving their Required Fund Deposits intact).<sup>47</sup> Loss allocation obligations would continue to be calculated based upon a Member's pro rata share of losses and liabilities (although the pro rata share would be calculated differently than it is today), and

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<sup>47</sup> NSCC believes that shifting from the two-step methodology of applying the Clearing Fund and then requiring Members to immediately replenish it, to requiring direct payment would increase efficiency while preserving the right to charge a Member's Clearing Fund deposits in the event the Member does not timely pay. Such a failure to pay would trigger recourse to the Clearing Fund deposits of the Member under proposed Section 3 of Rule 4. In addition, this change would provide greater stability for NSCC in times of stress by allowing NSCC to retain the Clearing Fund, its critical prefunded resource, while charging loss allocations. NSCC believes doing so would allow NSCC to cover its current credit exposures to Members at all times. By retaining the Clearing Fund as proposed, NSCC could use the Clearing Fund to secure the performance obligations of Members to NSCC, including their payment obligation for any loss allocation, while maintaining access to prefunded resources. By being able to manage its current credit exposures throughout the loss allocation process, NSCC would be able to continue to provide its critical operations and services during what would be expected to be a stressful period.

Members would still retain the ability to voluntarily withdraw from membership and cap their loss allocation obligation (although the loss allocation obligation would also be calculated differently than it is today).

The proposed rule change to Section 4 of Rule 4 would clarify that each Member that is a Member on the first day of an Event Period would be obligated to pay its pro rata share of losses and liabilities arising out of or relating to each Defaulting Member Event (other than a Defaulting Member Event with respect to which it is the Defaulting Member) and each Declared Non-Default Loss Event occurring during the Event Period. The proposal would make it clear that any Member for which NSCC ceases to act on a non-business day, triggering an Event Period that commences on the next business day, shall be deemed to be a Member on the first day of that Event Period.

Under the proposed rule change, a loss allocation “round” would mean a series of loss allocations relating to an Event Period, the aggregate amount of which is limited by the round cap. When the aggregate amount of losses allocated in a round equals the round cap, any additional losses relating to the applicable Event Period would be allocated in one or more subsequent rounds, in each case subject to a round cap for that round. NSCC may continue the loss allocation process in successive rounds until all losses from the Event Period are allocated among Members that have not submitted a Loss Allocation Withdrawal Notice in accordance with proposed Section 6 of Rule 4.

As proposed, each loss allocation would be communicated to Members by the issuance of a Loss Allocation Notice. Under the proposal, each Member’s pro rata share of losses and liabilities to be allocated in any round would be equal to (i) the Member’s

Average RFD divided by (ii) the sum of Average RFD amounts of all Members subject to loss allocation in such round.

Each Loss Allocation Notice would specify the relevant Event Period and the round to which it relates. The first Loss Allocation Notice in any first, second, or subsequent round would expressly state that such Loss Allocation Notice reflects the beginning of the first, second, or subsequent round, as the case may be, and that each Member in that round has five (5) business days from the issuance of such first Loss Allocation Notice for the round (such period, a “Loss Allocation Withdrawal Notification Period”) to notify NSCC of its election to withdraw from membership with NSCC pursuant to proposed Section 6 of Rule 4, and thereby benefit from its Loss Allocation Cap.<sup>48</sup> As proposed, the “Loss Allocation Cap” of a Member would be equal to the greater of (x) its Required Fund Deposit on the first day of the applicable Event Period and (y) its Average RFD.

NSCC is proposing to clarify that after a first round of loss allocation with respect to an Event Period, only Members that have not submitted a Loss Allocation Withdrawal Notice in accordance with proposed Section 6 of Rule 4 would be subject to further loss allocation with respect to that Event Period.

As proposed, Members would have two (2) business days after NSCC issues a first round Loss Allocation Notice to pay the amount specified in any such notice.<sup>49</sup> On a subsequent round (i.e., if the first round did not cover the entire loss of the Event Period because NSCC was only able to allocate up to the round cap), Members would also have

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<sup>48</sup> Supra note 18.

<sup>49</sup> Supra note 22.

two (2) business days after notice by NSCC to pay their loss allocation amounts (again subject to their Loss Allocation Caps), unless Members have notified (or will timely notify) NSCC of their election to withdraw from membership with respect to a prior loss allocation round pursuant to proposed Section 6 of Rule 4.

As proposed, Section 4 would also provide that, to the extent that a Member's Loss Allocation Cap exceeds the Member's Required Fund Deposit on the first day of the applicable Event Period, NSCC may in its discretion retain any excess amounts on deposit from the Member, up to the Member's Loss Allocation Cap.

Under the proposal, if a Member fails to make its required payment in respect of a Loss Allocation Notice by the time such payment is due, NSCC would have the right to proceed against such Member as a Member that has failed to satisfy an obligation in accordance with proposed Section 3 of Rule 4 described above. Members who wish to withdraw would be required to comply with the requirements in proposed Section 6 of Rule 4, described further below. Specifically, proposed Section 4 of Rule 4 would provide that if, after notifying NSCC of its election to withdraw from membership pursuant to proposed Section 6 of Rule 4, the Member fails to comply with the provisions of proposed Section 6 of Rule 4, its notice of withdrawal would be deemed void and any further losses resulting from the applicable Event Period may be allocated against it as if it had not given such notice.

Under the proposal, NSCC would delete the provision in current Section 4 of Rule 4 that requires NSCC to provide Members and the Commission with 5 business days' prior notice before applying the Clearing Fund to a loss or liability because such requirement would no longer be relevant under the proposed rule change. Under the

proposed rule change, NSCC would notify Members subject to loss allocation of the amounts being allocated to them in one or more Loss Allocation Notices. As proposed, instead of applying the Clearing Fund, NSCC would require Members to pay their loss allocation amounts (leaving their Clearing Fund deposits intact). In order to conform to these proposed rule changes, NSCC is proposing to eliminate the required notification to Members regarding the application of Clearing Fund in current Section 4 of Rule 4. NSCC is also proposing to delete the required notification to the Commission regarding the application of Clearing Fund in the same section. While as a practical matter, NSCC would notify the Commission of a decision to loss allocate, NSCC does not believe such notification needs to be specified in the Rules.

Under the proposed rule change, NSCC would move the provision related to Off-the-Market Transactions from current Section 3 of Rule 4 to proposed Section 4 of Rule 4 and clarify that (i) a loss or liability of NSCC in connection with the close-out or liquidation of an Off-the-Market Transaction would be allocated to the Member that was the counterparty to such transaction and (ii) no allocation would be made if the Defaulting Member satisfied all applicable intraday mark-to-market margin charges assessed by NSCC with respect to the Off-the-Market Transaction prior to its default.<sup>50</sup>

#### Section 6

Proposed Section 6 of Rule 4 would include the provisions regarding withdrawal from membership currently covered by Section 8 of Rule 4. NSCC believes that relocating the provisions on withdrawal from membership as it pertains to loss allocation,

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<sup>50</sup> See Securities Exchange Act Release No. 79598 (December 19, 2016), 81 FR 94462 (December 23, 2016) (SR-NSCC-2016-005), at 94465, and Securities Exchange Act Release No. 79592 (December 19, 2016), 81 FR 94448 (December 23, 2016) (SR-NSCC-2016-803), at 94452.

so that it comes right after the section on the loss allocation waterfall, would provide for the better organization of Rule 4. As proposed, the subheading for Section 6 would read “Withdrawal Following Loss Allocation.”

Currently, Section 8 of Rule 4 provides that participants may notify NSCC within ten (10) business days after receipt of notice of a pro rata charge that they have elected to terminate their membership and thereby avail themselves of a cap on loss allocation, which is currently their Required Deposit as fixed immediately prior to the time of the pro rata charge.

As stated above, under the proposed rule change, a Member who wishes to withdraw from membership in respect of a loss allocation round must provide notice of its election to withdraw (“Loss Allocation Withdrawal Notice”) within five (5) business days from the issuance of the first Loss Allocation Notice in any round.<sup>51</sup> In order to avail itself of its Loss Allocation Cap, the Member would need to follow the requirements in proposed Section 6 of Rule 4, which would provide that the Member must: (i) specify in its Loss Allocation Withdrawal Notice an effective date for withdrawal from membership, which date shall not be later than ten (10) business days following the last day of the Loss Allocation Withdrawal Notification Period (i.e., no later than ten (10) business days after the 5th business day following the first Loss Allocation Notice in that round of loss allocation),<sup>52</sup> (ii) cease all activity that would result in transactions being submitted to NSCC for clearance and settlement for which such Member would be obligated to perform, where the scheduled final settlement date

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<sup>51</sup> Supra note 18.

<sup>52</sup> Supra note 25.



would be later than the effective date of the Member's withdrawal, and (iii) ensure that all clearance and settlement activity for which such Member is obligated to NSCC is fully and finally settled by the effective date of the Member's withdrawal, including, without limitation, by resolving by such date all fails and buy-in obligations.

Proposed Section 6 of Rule 4 would provide that a Member that withdraws in compliance with the requirements of proposed Section 6 of Rule 4 would nevertheless remain obligated for its pro rata share of losses and liabilities with respect to any Event Period for which it is otherwise obligated under proposed Rule 4; however, the Member's aggregate obligation would be limited to the amount of its Loss Allocation Cap (as fixed in the round for which it withdrew).

NSCC is proposing to include a sentence in proposed Section 6 of Rule 4 to make it clear that if the Member fails to comply with the requirements set forth in that section, its Loss Allocation Withdrawal Notice will be deemed void, and the Member will remain subject to further loss allocations pursuant to proposed Section 4 of Rule 4 as if it had not given such notice.

Currently, Section 8 also contains provisions regarding additional pro rata charges that may be made by NSCC for the same loss or liability under the existing loss allocation process and the applicable caps that participants wishing to voluntarily terminate their membership after such additional pro rata charges are noticed may avail themselves of. These provisions would be replaced by the loss allocation process contained in proposed Section 4 described above.

#### Section 7

As proposed, Section 7 would cover the provisions on the return of a Member's Clearing Fund deposit that are currently covered by Section 6 of Rule 4. Proposed

Section 7's subheading would be "Return of Members' Clearing Fund Deposits" and would apply only to Members.

Currently, with respect to the return of Clearing Fund deposits, Section 6 of Rule 4 states that NSCC will return a participant's Clearing Fund deposit 90 days after 3 conditions are met: (i) the participant ceases to be a participant, (ii) all transactions open at the time the participant ceases to be a participant which could result in a charge to the Clearing Fund have been closed, and (iii) all obligations of the participant to NSCC have been satisfied or have been deducted from the participant's Clearing Fund deposit by NSCC, provided that the participant has provided NSCC with satisfactory indemnities or guarantees or another participant has been substituted on all transactions and obligations of the participant.

Current Section 6 provides further that in the absence of an acceptable guarantee, indemnity or substitution, NSCC will retain the entire Clearing Fund deposit of a participant if such deposit is less than \$100,000 for two (2) years (or four (4) years for Members who have Sponsored Accounts at a Qualified Securities Depository) after conditions described in (i), (ii) and (iii) of the paragraph above have occurred. If the participant's Clearing Fund deposit is equal to or greater than \$100,000, NSCC will retain the greater of twenty-five (25) percent of a participant's average Clearing Fund requirement over the twelve (12) months immediately prior to the date the participant ceased to be a participant, or \$100,000 for two (2) years (or four (4) years for Members who have Sponsored Accounts at a Qualified Securities Depository) after conditions described in (i), (ii) and (iii) of the paragraph above have occurred.

Current Section 6 states that if a participant made a deposit with respect to the Mutual Fund Services or Insurance and Retirement Processing Services, the participant will be entitled to the return of this deposit ninety (90) days after all associated transactions in these services have been satisfied.

Finally, Section 6 currently provides that any obligation of a participant to NSCC unsatisfied at the time the participant ceases to be a participant will not be affected by such cessation of membership.

Proposed Section 7 would reduce the period in which NSCC may retain a Member's Clearing Fund deposit. Specifically, NSCC proposes that if a Member gives notice to NSCC of its election to withdraw from membership, NSCC will return the Member's Actual Deposit in the form of (i) cash or securities within thirty (30) calendar days and (ii) Eligible Letters of Credit within ninety (90) calendar days, after all of the Member's transactions have settled and all matured and contingent obligations to NSCC for which the Member was responsible while a Member have been satisfied, except NSCC may retain for up to two (2) years the Actual Deposits from Members who have Sponsored Accounts at DTC. NSCC believes that shortening the time periods for the return of a Member's Clearing Fund deposit would be helpful to firms who have exited NSCC so that they could have use of the deposits sooner than under the current Rules, while at the same time protecting NSCC because such return would only occur if all obligations of the terminating Member to NSCC have been satisfied. Proposed Section 7 would also harmonize the retention period for a Member's deposits to the Clearing Fund

with the FICC/GSD Rules,<sup>53</sup> thus providing consistent treatment for firms that are members of both NSCC and FICC. Similarly, the Clearing Fund deposit retention for Members who have Sponsored Accounts at DTC would be reduced in order to stay consistent with the proposed retention period in the rules of DTC.<sup>54</sup> In addition, NSCC proposes to make it clear that a Member's obligations to NSCC would include both matured as well as contingent obligations.

#### Section 8

Proposed Section 8 of Rule 4 would cover the subject matter currently covered in Section 7 of Rule 4. Proposed Section 8's subheading would be "Changes in Members' Required Fund Deposits" and would apply only to Members.

Currently, Section 7 of Rule 4 requires participants to satisfy any increase in their Required Deposit within such time as NSCC requires. At the time the increase becomes effective, the participant's obligations to NSCC will be determined in accordance with the increased Required Deposit whether or not the Member has so increased its deposit.

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<sup>53</sup> Section 10 of FICC/GSD Rule 4, in relevant part, states that "If a Netting Member gives notice to the Corporation pursuant to Rule 3 of its election to terminate its membership in the Netting System, the Member's deposits to the Clearing Fund in the form of cash or securities shall be returned to it within 30 calendar days thereafter ... provided that all amounts owing to the Corporation by the Member have been paid to the Corporation prior to such return and the Member has no remaining open Net Settlement Position, Fail Net Settlement Position, or Forward Net Settlement Position." Supra note 31.

<sup>54</sup> On December 18, 2017, DTC submitted a proposed rule change and an advance notice to enhance its rules regarding allocation of losses. See Securities Exchange Act Release Nos. 82426 (January 2, 2018), 83 FR 913 (January 8, 2018) (SR-DTC-2017-022) and 82582 (January 24, 2018), 83 FR 4297 (January 30, 2018) (SR-DTC-2017-804). On June 28, 2018, DTC submitted amendments to the proposed rule change and advance notice. Copies of the amendments to the proposed rule change and the advance notice are available at <http://www.dtcc.com/legal/sec-rule-filings.aspx>.

NSCC is not proposing any substantive changes to this provision, which will be renumbered as Section 8 of Rule 4 under the proposed rule change, except for streamlining the provision and limiting its application to Members as stated above.

#### Section 9

Currently, Section 9 of Rule 4 addresses situations where a participant has excess deposits in the Clearing Fund (i.e., amounts above its Required Deposit). The current provision provides that NSCC will, on any day that NSCC has determined and provided notification that an excess deposit exists with respect to a participant, return an excess amount requested by a participant that follows the formats and timeframe established by NSCC for such request. The current provision makes clear that NSCC will not return the requested excess amount (i) until any amount required to be charged against the participant's Required Deposit is paid by the participant to NSCC and/or (ii) if NSCC determines that the participant's current month's use of one or more services is materially different than the previous month's use upon which such excess is based. Section 9 currently makes clear that, notwithstanding any of the foregoing, NSCC may, in its discretion, withhold any or all of a participant's excess deposit if the participant has been placed on the Watch List.<sup>55</sup> Current Section 9 also makes clear that nothing in this section limits NSCC's rights under Rule 15.<sup>56</sup>

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<sup>55</sup> Pursuant to Section 4 of Rule 2B, a Member could be placed on the Watch List either based on its credit rating of 5, 6 or 7, which can either be generated by the Credit Risk Rating Matrix or from a manual downgrade, or when NSCC deems such placement as necessary to protect NSCC and its Members. Supra note 5.

<sup>56</sup> Rule 15 permits NSCC to require a Member, Limited Member or any applicant to become either to furnish NSCC adequate assurances of the entity's financial responsibility and operational capability as NSCC may deem necessary. Supra note 5.

Proposed Section 9 would add a subheading “Excess Clearing Fund Deposits” and would apply only to Members. NSCC is not proposing any substantive changes to this provision, except for streamlining the provisions in this section and eliminating the condition described in clause (i) of the paragraph above that limits participants’ ability to request the return of excess amounts on deposit in the Clearing Fund and replacing clause (ii) of the paragraph above with a clause that provides NSCC may, in its discretion, withhold any or all of a participant’s excess deposit if NSCC determines that the Member’s anticipated activities in NSCC in the near future may reasonably be expected to be materially different than its activities of the recent past. NSCC believes that the proposed additional clause would protect NSCC and its participants because the clause would allow NSCC to retain excess deposits to cover an expected near-term increase in a Member’s Required Fund Deposit amount due to the anticipated change in the Member’s activities. The proposed additional clause would also align NSCC’s Rules with that of FICC/GSD and FICC/MBSD,<sup>57</sup> thus providing consistent treatment for firms that are members of both NSCC and FICC.

#### Section 10

Current Section 10 of Rule 4 provides for crediting persons against whom losses are charged pursuant to Rule 4 if there is a subsequent recovery of such losses by NSCC. NSCC is not proposing any changes to this section other than (i) making it clear that no loss allocation under proposed Rule 4 would constitute a waiver of any claim NSCC may have against a Member for any losses or liabilities to which the Member is subject under

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<sup>57</sup> See Section 9 of FICC/GSD Rule 4 (Clearing Fund and Loss Allocation) and Section 9 of FICC/MBSD Rule 4 (Clearing Fund and Loss Allocation). Supra note 31.

the Rules, including, without limitation, any loss or liability to which it may be subject under proposed Rule 4, and (ii) adding a subheading “No Waiver; Subsequent Recovery Against Loss Amounts” and replacing “persons” with “Persons,” which is currently defined in Rule 1 (Definitions and Descriptions) to mean “a partnership, corporation, limited liability corporation or other organization, entity or an individual.” NSCC is proposing the change in (i) above to preserve its legal rights and to make it clear to Members that loss allocation under proposed Rule 4 would not be deemed as NSCC waiving any claims it may have against a Member for any losses or liabilities to which the Member is subject under the Rules. With respect to the proposed change in (ii) above, given that NSCC is a corporation, NSCC believes that the term “Person” already includes NSCC; however, for increased clarity, NSCC is proposing to add “including the Corporation” to make it clear to Members that if there is a subsequent recovery of losses charged pursuant to Rule 4, the net amount of the recovery would be credited to Persons, including NSCC, against whom the loss was charged in proportion to the amounts charged against them.

### Section 11

Current Section 11 of Rule 4 provides that a participant may withdraw Eligible Clearing Fund Securities from pledge, provided that the participant has deposited cash with, or pledged additional Eligible Clearing Fund Securities to, NSCC that, in the aggregate, secure the open account indebtedness of the participant and/or satisfy the participant’s Required Deposit. Proposed Section 11 would add a subheading “Substitution or Withdrawal of Pledged Securities” and would apply only to Members. NSCC is not proposing any substantive changes to this provision, except for changes to improve the transparency and accessibility of this section.

### Section 12

Current Section 12 of Rule 4 makes it clear that NSCC has certain rights with respect to the Clearing Fund. Proposed Section 12 would add a subheading “Authority of Corporation” and would apply only to Members. NSCC is not proposing any substantive changes to this provision, except to clarify that a reference to 30 days in current Section 12 would mean 30 calendar days.

### Section 13

NSCC is proposing to add a new Section 13 to Rule 4 that would be entitled “Mutual Fund Deposits.” Under the proposal, NSCC would consolidate provisions from various sections in the current Rule 4 concerning Mutual Fund/Insurance Services Members and Fund Members and group them into proposed Section 13. Aside from the consolidation, NSCC is not proposing any substantive changes to these provisions, except for changes to (i) reduce NSCC’s retention period of Mutual Fund Deposits when a Mutual Fund Participant (as defined below and in the proposed rule change) elects to withdraw from membership, in order to harmonize it with the proposed change in Section 7, as described above, and (ii) improve the transparency and accessibility of the provisions.

Proposed Section 13 would provide that each Member that uses the Mutual Fund Services to submit mutual fund purchases, redemptions, or exchanges to any Fund Member or another Member and each Mutual Fund/Insurance Services Member would, and each Fund Member (collectively with such Members and Mutual Fund/Insurance Services Members, “Mutual Fund Participants”) may, be required to make a cash deposit to the Clearing Fund in the amounts determined in accordance with Procedure XV and other applicable Rules (its “Mutual Fund Deposit” and, unless specified otherwise, for the



purposes of the Rules, Required Fund Deposits shall include Mutual Fund Deposits). In the case of a Member, its Mutual Fund Deposit would be a separate and additional component of such Member's deposit to the Clearing Fund but not part of the Member's Required Fund Deposit for purposes of calculating pro rata loss allocations pursuant to proposed Section 4 of Rule 4.

As in the current Rules, proposed Section 13 would also provide that if any Mutual Fund Participant fails to satisfy any obligation to NSCC relating to Mutual Fund Services, notwithstanding NSCC's right to reverse in whole or in part any credit previously given to the contra side to any outstanding Mutual Fund Services transaction of the Mutual Fund/Insurance Services Member, NSCC would first apply such Mutual Fund Participant's Mutual Fund Deposit. If after such application any loss or liability remains and if such Mutual Fund Participant is a Member that is not otherwise obligated to NSCC, NSCC would apply such Member's Actual Deposit in accordance with proposed Section 3 of Rule 4. NSCC would next allocate any further remaining loss or liability to the other Mutual Fund Participants in successive rounds of loss allocations in each case up to the aggregate of Mutual Fund Deposits from non-defaulting Mutual Fund Participants, and after the first such round, Mutual Fund Participants that have not submitted a Loss Allocation Withdrawal Notice in accordance with proposed Section 6 of Rule 4, following the procedures and timeframes set forth in proposed Sections 4 and 6 of Rule 4 as if such Mutual Fund Participants are Members. If any loss or liability remains thereafter and there are no continuing Mutual Fund Participants, NSCC would proceed with loss allocations to Members for a Defaulting Member Event in accordance with proposed Section 4 of Rule 4.

As proposed, Section 13 would reduce NSCC's retention period of Mutual Fund Deposits from ninety (90) days under the current Section 6 of Rule 4 to thirty (30) calendar days. Specifically, NSCC is proposing that a Mutual Fund Participant that elects to withdraw from membership would be entitled to the return of its Mutual Fund Deposit no later than thirty (30) calendar days after all of its transactions have settled and it has satisfied all of its matured and contingent obligations to NSCC for which such Mutual Fund Participant was responsible while a Mutual Fund Participant. NSCC is proposing this change in order to harmonize the retention period of Mutual Fund Deposit with the proposed Clearing Fund retention period in proposed Section 7 of Rule 4, as described above.

As proposed, Section 13 would make it clear that NSCC's rights, authority and obligations with respect to deposits to the Clearing Fund as set forth in Rule 4 would apply to Mutual Fund Deposits.

#### Section 14

NSCC is proposing to add a new Section 14 to Rule 4 that would be entitled "Insurance Deposits." Under the proposal, NSCC would consolidate provisions from various sections in current Rule 4 concerning Insurance Carrier/Retirement Services Members and group them into proposed Section 14. Aside from the consolidation, NSCC is not proposing any substantive changes to these provisions, except for changes to (i) reduce NSCC's retention period of Insurance Deposits when an Insurance Participant (as defined below and in the proposed rule change) elects to withdraw from membership, in order to harmonize it with proposed Section 7, as described above, and (ii) improve the transparency and accessibility of the provisions.

As in the current Rules, proposed Section 14 would provide that each Mutual Fund/Insurance Services Member that uses the Insurance and Retirement Processing Services and each Insurance Carrier/Retirement Services Member (collectively, “Insurance Participants”) may be required to make a cash deposit to the Clearing Fund in the amounts determined in accordance with Procedure XV and other applicable Rules (its “Insurance Deposit” and, unless specified otherwise, for the purposes of the Rules, Required Fund Deposits shall include Insurance Deposits). Proposed Section 14 would also provide that if any Insurance Participant fails to satisfy any obligation to NSCC relating to the Insurance and Retirement Processing Services, NSCC would first apply such Insurance Participant’s Insurance Deposit. If after such application any loss or liability remains, NSCC would allocate the remaining loss or liability to the other Insurance Participants in successive rounds of loss allocations in each case up to the aggregate of Insurance Deposits from non-defaulting Insurance Participants, and after the first such round, Insurance Participants that have not submitted a Loss Allocation Withdrawal Notice in accordance with proposed Section 6 of Rule 4, following the procedures and timeframes set forth in proposed Sections 4 and 6 of Rule 4 as if such Insurance Participants are Members. If any loss or liability remains thereafter and there are no continuing Insurance Participants, NSCC would proceed with loss allocations to Members for a Defaulting Member Event in accordance with proposed Section 4 of Rule 4.

As proposed, Section 14 would reduce NSCC’s retention period of Insurance Deposits from ninety (90) days under the current Section 6 of Rule 4 to thirty (30) calendar days. Specifically, NSCC is proposing that an Insurance Participant that elects

to withdraw from membership would be entitled to the return of its Insurance Deposit no later than thirty (30) calendar days after all of its transactions have settled and it has satisfied all of its matured and contingent obligations to NSCC for which such Insurance Participant was responsible while an Insurance Participant. NSCC is proposing this change in order to harmonize the retention period of Insurance Deposit with the proposed Clearing Fund retention period in proposed Section 7 of Rule 4, as described above.

As proposed, Section 14 would make it clear that NSCC's rights, authority and obligations with respect to deposits to the Clearing Fund as set forth in Rule 4 would apply to Insurance Deposits.

B. Proposed Changes to Addendum E (Statement of Policy – Application of Retained Earnings – Member Impairments) and Addendum K (Interpretation of the Board of Directors – Application of Clearing Fund)

Addendum E is a statement of policy that currently provides that NSCC will apply no less than twenty-five (25) percent of its retained earnings to cover losses or liabilities from a Member's impairment that is not otherwise satisfied by the impaired Member's Clearing Fund deposit. NSCC is proposing to delete Addendum E in its entirety because it would no longer be relevant given the proposed rule change relating to the Corporate Contribution discussed above.

NSCC is proposing to modify Addendum K to delete all provisions associated with loss allocation and application of the Clearing Fund in connection with a loss or liability incurred by NSCC, including modifying the title of Addendum K. These provisions would no longer be necessary under the proposed rule change because the loss allocation process in its entirety would be governed by Rule 4. In addition, the current language in Addendum K regarding allocation by System would no longer be applicable

under the proposed rule change as described above. NSCC would retain the provisions in Addendum K that pertain to NSCC's guaranty and rename Addendum K "The Corporation's Guaranty." NSCC is also proposing to replace "Rules" with "Rules and Procedures" to better reflect the name of NSCC's rulebook.

(iii) Other Proposed Rule Changes

NSCC is proposing changes to Rule 1 (Definitions and Descriptions), Rule 2B (Ongoing Membership Requirements and Monitoring), Rule 4(A) (Supplemental Liquidity Deposits), Rule 13 (Exception Processing), Rule 15 (Assurances of Financial Responsibility and Operational Capability), Rule 42 (Wind-Down of a Member, Fund Member or Insurance Carrier/Retirement Services Member), Procedure III (Trade Recording Service (Interface with Qualified Clearing Agencies)), Procedure XV (Clearing Fund Formula and Other Matters), and Addendum O (Admission of Non-US Entities as Direct NSCC Members). NSCC is proposing changes to these Rules in order to conform them with the proposed changes to Rule 4 as well as to make certain technical changes to these Rules.

Specifically, NSCC is proposing to add the following defined terms to Rule 1, in alphabetical order: Actual Deposit, Average RFD, Clearing Fund Cash, Corporate Contribution, Declared Non-Default Loss Event, Defaulting Member, Defaulting Member Event, Eligible Letter of Credit, Event Period, Insurance Deposit, Insurance Participant, Issuer, Lender, Loss Allocation Cap, Loss Allocation Notice, Loss Allocation Withdrawal Notice, Loss Allocation Withdrawal Notification Period, Mutual Fund Deposit, Mutual Fund Participant, Required Fund Deposit, Termination Date, and Voluntary Termination Notice.

NSCC is proposing to delete the defined term “The Corporation” in Rule 1 and replace it with “Corporation” in Rule 1. NSCC is proposing to replace “Required Deposits” with “Required Fund Deposits” in Rule 2B, Rule 4(A), Rule 15, Rule 42, Procedure III, and Procedure XV. NSCC is proposing to replace “Rules” with “Rules and Procedures” in Rule 1, Rule 2B, Rule 13, Rule 15, and Procedure III. NSCC is also proposing to replace “Letter of Credit” with “Eligible Letter of Credit” in Rule 42 and Addendum O.

In addition, in Section 5 of Rule 2B, NSCC proposes to change the reference to Section 8 of Rule 4 to reflect the updated section number, which would be to Section 4 of Rule 4. NSCC is also proposing conforming changes to this section to ensure that termination provisions in the Rules, whether voluntary or in response to a loss allocation, are consistent with one another to the extent appropriate.

Currently, Section 5 of Rule 2B provides that participants may elect to voluntarily retire their membership by providing NSCC with written notice of such termination. Such termination will not be effective until accepted by NSCC, which shall be evidenced by a notice to NSCC’s participants announcing the participant’s retirement and the effective date of the retirement, which is defined as the “Retirement Date.” This section also provides that a participant’s voluntary termination of membership shall not affect its obligations to NSCC.

Where appropriate, NSCC is proposing changes to align Section 5 of Rule 2B with the proposed new Section 6 of Rule 4, both of which address termination of membership. Specifically, NSCC is proposing to rename the subheading of Section 5 of Rule 2B to “Voluntary Termination” and to change “retirement” to “termination” and

“Retirement Date” to “Termination Date” throughout Section 5 of Rule 2B. NSCC is also proposing to provide that when a participant elects to voluntarily terminate its membership by providing NSCC a written notice of such termination (“Voluntary Termination Notice”), the participant must specify in its Voluntary Termination Notice a desired date for its withdrawal, provided such date shall not be prior to the scheduled final settlement date of any remaining obligation owed by the participant to NSCC as of the time such Voluntary Termination Notice is submitted to NSCC, unless otherwise approved by NSCC. NSCC is retaining the provision that makes it clear that the termination will not be effective until accepted by NSCC.<sup>58</sup> NSCC is also retaining the provision that describes NSCC’s acceptance of the termination; however, NSCC is proposing to make it clear that such acceptance, as evidenced by a notice to NSCC’s participants, would (i) be no later than ten (10) business days after the receipt of the Voluntary Termination Notice from the participant and (ii) announce the last trade date for the participant instead of the Termination Date. In addition, NSCC is proposing to make it clear that the Termination Date would be the final settlement date of all transactions of the participant. NSCC is proposing these clarifying changes so that the Rules would align more closely with NSCC’s current practice.

As an example, Member A submits a Voluntary Termination Notice to NSCC on April 1st indicating its desired termination date is June 15th. NSCC would accept such

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<sup>58</sup> Unlike the Voluntary Termination Notice, the Loss Allocation Withdrawal Notice as proposed in Section 6 of Rule 4 does not require explicit acceptance by NSCC to be effective. NSCC believes that requiring explicit acceptance of the Loss Allocation Withdrawal Notice could complicate the loss allocation process and potentially result in membership withdrawal being delayed as well as detract from the objective to have NSCC know on a timely basis which Members would remain subject to the subsequent rounds of loss allocation.

termination request by issuing a notice to Members within 10 business days from April 1<sup>st</sup>; such notice would provide that the last trade date for Member A is June 12<sup>th</sup>, and the effective date of Member A's NSCC membership termination would be the final settlement date of all transactions of Member A. In contrast, if Member A submits a Voluntary Termination Notice on April 1<sup>st</sup> and indicates its desired termination date is April 5<sup>th</sup>, NSCC would either (i) accept such termination notice by issuing a notice to Members on or before April 5<sup>th</sup>; such notice would provide that the last trade date for Member A is April 2<sup>nd</sup>, and the effective date of Member A's NSCC membership termination would be the final settlement date of all transactions of Member A, or (ii) if NSCC requires additional time to process the termination, NSCC would accept such termination notice by issuing notice to Members after April 5<sup>th</sup> but still within 10 business days from April 1<sup>st</sup>; such notice would provide that the last trade date for Member A is a date after April 2<sup>nd</sup>, and the effective date of Member A's NSCC membership termination would be the final settlement date of all transactions of Member A.

NSCC is also proposing to clarify that after the close of business on the Termination Date,<sup>59</sup> a participant that terminates its membership shall no longer be eligible or required to submit transactions to NSCC for clearance and settlement, unless the Board of Directors determines otherwise in order to ensure an orderly liquidation of the participant's open obligations. If any transaction is submitted to NSCC by such participant that is scheduled to settle after the Termination Date, the participant's Voluntary Termination Notice would be deemed void and the participant would remain

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<sup>59</sup> Account(s) of a terminating participant are generally deactivated after the close of business on the Termination Date.



subject to the Rules as if it had not given such notice. Furthermore, NSCC is proposing to add a sentence to Section 5 of Rule 2B to refer participants to Sections 7, 13 and 14 of Rule 4, as applicable, regarding provisions on the return of a participant's Clearing Fund deposit and to specify that if an Event Period were to occur after a participant has submitted its Voluntary Termination Notice but on or prior to the Termination Date, in order for such participant to benefit from its Loss Allocation Cap pursuant to Section 4 of Rule 4, the participant would need to comply with the provisions of Section 6 of Rule 4 and submit a Loss Allocation Withdrawal Notice, which notice, upon submission, would supersede and void any pending Voluntary Termination Notice previously submitted by the participant. As an example, if an Event Period occurs after submission of the Voluntary Termination Notice by a Member but on or prior to the Termination Date, and the Member does not subsequently submit a Loss Allocation Withdrawal Notice as proposed in Section 6 of Rule 4, then the Member would not benefit from its Loss Allocation Cap, i.e., the Member would remain obligated for its pro rata share of losses and liabilities with respect to any Event Period that commenced on or prior to the Termination Date.

In Rule 4(A), NSCC proposes to amend Section 11 to update a cross-reference to the time period for the refund of deposits to the Clearing Fund when a Member ceases to be a participant in order to align it with proposed Section 7 of Rule 4, which would reduce the time period from 90 days to 30 calendar days. NSCC is also proposing to add a reference to Section 13 of Rule 4 in clause (c) of Section 13 of Rule 4(A) in order to specify that a Special Activity Supplemental Deposit of a Member may be used to satisfy a loss or liability as provided in such new proposed Section 13. NSCC is also proposing

technical changes in Sections 2 and 13 of Rule 4(A) to reflect new proposed defined terms in the Rules.

In Rule 13, NSCC would replace “System” with “system” to reflect the proposed deletion of “System” as a defined term from Rule 4 and Addendum K. In Procedure XV, NSCC would replace “Qualified Securities Depository” with “DTC” to be consistent with the proposed change in Section 1 of Rule 4.

#### Member Outreach

Beginning in August 2017, NSCC conducted outreach to Members in order to provide them with advance notice of the proposed changes. As of the date of this filing, no written comments relating to the proposed changes have been received in response to this outreach. The Commission will be notified of any written comments received.

#### Implementation Timeframe

Pending Commission approval, NSCC expects to implement this proposal within two (2) business days after approval. Members would be advised of the implementation date of this proposal through issuance of an NSCC Important Notice.

#### *Expected Effect on Risks to the Clearing Agency, its Participants and the Market*

NSCC believes that the proposed rule changes to enhance the resiliency of NSCC’s loss allocation process and to shorten the time within which NSCC is required to return a former Member’s Clearing Fund deposit would reduce the risk of uncertainty to NSCC, its Members and the market overall. Specifically, by modifying the calculation of NSCC’s corporate contribution, NSCC would apply a mandatory fixed percentage of its General Business Risk Capital Requirement (as compared to the current Rules which provide for “no less than” a percentage of retained earnings), which would provide greater transparency and accessibility to Members as to how much NSCC would

contribute in the event of a loss or liability. By modifying the application of NSCC's corporate contribution to apply to Declared Non-Default Loss Events, in addition to Defaulting Member Events, on a mandatory basis, NSCC would expand the application of its corporate contribution beyond losses and liabilities from Member impairments, which would better align the interests of NSCC with those of its Members by stipulating a mandatory application of the Corporate Contribution to a Declared Non-Default Loss Event prior to any allocation of the loss among Members. Taken together, these proposed rule changes would enhance the overall resiliency of NSCC's loss allocation process by enhancing the calculation and application of NSCC's Corporate Contribution, which is one of the key elements of NSCC's loss allocation process. Moreover, by providing greater transparency and accessibility to Members, as stated above, the proposed rule changes regarding the Corporate Contribution, including the proposed replenishment period, would allow Members to better assess the adequacy of NSCC's loss allocation process.

By introducing the concept of an Event Period, NSCC would be able to group Defaulting Member Events and Declared Non-Default Loss Events occurring in a period of ten (10) business days for purposes of allocating losses to Members. NSCC believes that the Event Period would provide a defined structure for the loss allocation process to encompass potential sequential Defaulting Member Events or Declared Non-Default Loss Events that are likely to be closely linked to an initial event and/or market dislocation episode. Having this structure would enhance the overall resiliency of NSCC's loss allocation process because NSCC would be better equipped to address losses that may arise from multiple Defaulting Member Events and/or Declared Non-Default Loss Events

that arise in quick succession. Moreover, the proposed Event Period structure would provide certainty for Members concerning their maximum exposure to mutualized losses with respect to such events.

By introducing the concept of “rounds” (and accompanying Loss Allocation Notices) and applying this concept to the timing of loss allocation payments and the Member withdrawal process in connection with the loss allocation process, NSCC would (i) set forth a defined amount that it would allocate to Members during each round (i.e., the round cap), (ii) advise Members of loss allocation obligation information as well as round information through the issuance of Loss Allocation Notices, and (iii) provide Members with the option to limit their loss allocation exposure after the issuance of the first Loss Allocation Notice in each round. These proposed rule changes would enhance the overall resiliency of NSCC’s loss allocation process because they would enable NSCC to continue the loss allocation process in successive rounds until all of NSCC’s losses are allocated and enable NSCC to identify continuing Members for purposes of calculating subsequent loss allocation obligations in successive rounds. Moreover, the proposed rule changes would define for Members a clear manner and process in which they could cap their loss allocation exposure to NSCC.

By implementing a “look-back” period to calculate a Member’s loss allocation obligations and its Loss Allocation Cap, NSCC would discourage Members from reducing their settlement activity during a time of stress primarily to limit their loss allocation obligations. By determining a Member’s loss allocation obligations based on the average of its Required Fund Deposit over a look-back period and its Loss Allocation Cap based on the greater of its Required Fund Deposit or the average thereof over a look-

back period, NSCC would be able to calculate a Member's pro rata share of losses and liabilities based on the amount of risk that the Member brings to NSCC. These proposed rule changes would enhance the overall resiliency of NSCC's loss allocation process because they would deter Members from reducing their settlement activity during a time of stress primarily to limit their Loss Allocation Caps.

By reducing the time within which NSCC is required to return a former Member's Clearing Fund deposit, NSCC would enable firms that have exited NSCC to have access to their funds sooner than under the current Rules, while at the same time protecting NSCC and its provision of clearance and settlement services because such return would only occur if all obligations of the terminating Member to NSCC have been satisfied. As such, NSCC would maintain the requisite level of Clearing Fund deposit to ensure that it can continue to meet its clearance and settlement obligations.

#### *Management of Identified Risks*

NSCC is proposing the rule changes as described in detail above in order to enhance the resiliency of NSCC's loss allocation process and provide transparency and accessibility to Members regarding NSCC's loss allocation process.

#### *Consistency with the Clearing Supervision Act*

The proposed rule change would be consistent with Section 805(b) of the Clearing Supervision Act.<sup>60</sup> The objectives and principles of Section 805(b) of the Clearing Supervision Act are to promote robust risk management, promote safety and soundness, reduce systemic risks, and support the stability of the broader financial system.<sup>61</sup>

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<sup>60</sup> 12 U.S.C. 5464(b).

<sup>61</sup> Id.

The proposed rule change would enhance the resiliency of NSCC's loss allocation process by (1) modifying the calculation and application of NSCC's corporate contribution, (2) introducing an Event Period, (3) introducing the concept of "rounds" (and accompanying Loss Allocation Notices) and applying this concept to the timing of loss allocation payments and the Member withdrawal process in connection with the loss allocation process, and (4) implementing a "look-back" period to calculate a Member's loss allocation obligation (which would replace the current calculation of a Member's loss allocation obligation based on the Member's activity in each of the various services or "Systems" offered by NSCC) and its Loss Allocation Cap. Together, these proposed rule changes would (i) create greater certainty for Members regarding NSCC's obligation towards a loss, (ii) more clearly specify NSCC's and Members' obligations toward a loss and balance the need to manage the risk of sequential defaults and other potential loss events against Members' need for certainty concerning their maximum exposures, and (iii) provide Members the opportunity to limit their exposure to NSCC by capping their exposure to loss allocation. Reducing the risk of uncertainty to NSCC, its Members and the market overall would promote robust risk management, promote safety and soundness, reduce systemic risks, and support the stability of the broader financial system. Therefore, NSCC believes that the proposed rule change to enhance the resiliency of NSCC's loss allocation process is consistent with the objectives and principles of Section 805(b) of the Clearing Supervision Act cited above.

By reducing the time within which NSCC is required to return a former Member's Clearing Fund deposit, NSCC would enable firms that have exited NSCC to have access to their funds sooner than under the current Rules while at the same time protecting

NSCC and its provision of clearance and settlement services because such return would only occur if all obligations of the terminating Member to NSCC have been satisfied. As such, NSCC would maintain the requisite level of Clearing Fund deposit to ensure that it can continue to meet its clearance and settlement obligations. Enabling NSCC to continue to meet its clearance and settlement obligations would promote robust risk management, promote safety and soundness, reduce systemic risks, and support the stability of the broader financial system. Therefore, NSCC believes that this proposed rule change is consistent with the objectives and principles of Section 805(b) of the Clearing Supervision Act cited above.

The proposed rule change is also consistent with Rules 17Ad-22(e)(13) and 17Ad-22(e)(23)(i), promulgated under the Act.<sup>62</sup> Rule 17Ad-22(e)(13) under the Act requires, in part, that NSCC establish, implement, maintain and enforce written policies and procedures reasonably designed to ensure NSCC has the authority and operational capacity to take timely action to contain losses and continue to meet its obligations.<sup>63</sup> As described above, the proposed rule changes to (1) modify the calculation and application of NSCC's corporate contribution, (2) introduce an Event Period, (3) introduce the concept of "rounds" (and accompanying Loss Allocation Notices) and apply this concept to the timing of loss allocation payments and the Member withdrawal process in connection with the loss allocation process, and (4) implement a "look-back" period to calculate a Member's loss allocation obligation (which would replace the current calculation of a Member's loss allocation obligation based on the Member's activity in

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<sup>62</sup> 17 CFR 240.17Ad-22(e)(13) and (e)(23)(i).

<sup>63</sup> 17 CFR 240.17Ad-22(e)(13).

each of the various services or “Systems” offered by NSCC) and its Loss Allocation Cap, taken together, are designed to enhance the resiliency of NSCC’s loss allocation process. Having a resilient loss allocation process would help ensure that NSCC can effectively and timely address losses relating to or arising out of either the default of one or more Members or one or more non-default loss events, which in turn would help NSCC contain losses and continue to meet its clearance and settlement obligations. Therefore, NSCC believes that the proposed rule changes to enhance the resiliency of NSCC’s loss allocation process are consistent with Rule 17Ad-22(e)(13) under the Act.

Rule 17Ad-22(e)(23)(i) under the Act requires NSCC to establish, implement, maintain and enforce written policies and procedures reasonably designed to publicly disclose all relevant rules and material procedures, including key aspects of NSCC’s default rules and procedures.<sup>64</sup> The proposed rule changes to (i) align the loss allocation rules of the DTCC Clearing Agencies, (ii) improve the overall transparency and accessibility of the provisions in the Rules governing loss allocation, and (iii) make conforming and technical changes, would not only ensure that NSCC’s loss allocation rules are, to the extent practicable and appropriate, consistent with the loss allocation rules of other DTCC Clearing Agencies, but also would help to ensure that NSCC’s loss allocation rules are transparent and clear to Members. Aligning the loss allocation rules of the DTCC Clearing Agencies would provide consistent treatment, to the extent practicable and appropriate, especially for firms that are participants of two or more DTCC Clearing Agencies. Having transparent and clear loss allocation rules would enable Members to better understand the key aspects of NSCC’s default rules and

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<sup>64</sup> 17 CFR 240.17Ad-22(e)(23)(i).



procedures and provide Members with increased predictability and certainty regarding their exposures and obligations. As such, NSCC believes that the proposed rule changes to align the loss allocation rules of the DTCC Clearing Agencies as well as to improve the overall transparency and accessibility of NSCC's loss allocation rules are consistent with Rule 17Ad-22(e)(23)(i) under the Act.

Similarly, the proposed rule changes to NSCC's voluntary termination provisions would improve the clarity of the Rules and help to ensure that NSCC's voluntary termination process is transparent and clear to Members. Having clear voluntary termination provisions would enable Members to better understand NSCC's voluntary termination process and provide Members with increased predictability and certainty regarding their rights and obligations with respect to such process. As such, NSCC believes that the proposed rule changes to the voluntary termination provision are also consistent with Rule 17Ad-22(e)(23)(i) under the Act.

### III. Date of Effectiveness of the Advance Notice, and Timing for Commission Action

The proposed change may be implemented if the Commission does not object to the proposed change within 60 days of the later of (i) the date that the proposed change was filed with the Commission or (ii) the date that any additional information requested by the Commission is received. The clearing agency shall not implement the proposed change if the Commission has any objection to the proposed change.

A proposed change may be implemented in less than 60 days from the date the advance notice is filed, or the date further information requested by the Commission is received, if the Commission notifies the clearing agency in writing that it does not object

to the proposed change and authorizes the clearing agency to implement the proposed change on an earlier date, subject to any conditions imposed by the Commission.

The clearing agency shall post notice on its website of proposed changes that are implemented.

The proposal shall not take effect until all regulatory actions required with respect to the proposal are completed.

#### IV. Solicitation of Comments

Interested persons are invited to submit written data, views and arguments concerning the foregoing. Comments may be submitted by any of the following methods:

##### Electronic Comments:

- Use the Commission's Internet comment form  
(<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-NSCC-2017-806 on the subject line.

##### Paper Comments:

- Send paper comments in triplicate to Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-NSCC-2017-806. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet website (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent

amendments, all written statements with respect to the Advance Notice that are filed with the Commission, and all written communications relating to the Advance Notice between the Commission and any person, other than those that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for website viewing and printing in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549 on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of the filing also will be available for inspection and copying at the principal office of NSCC and on DTCC's website (<http://dtcc.com/legal/sec-rule-filings.aspx>). All comments received will be posted without change. Persons submitting comments are cautioned that we do not redact or edit personal identifying information from comment submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-NSCC-2017-806 and should be submitted on or before [insert date 15 days from publication in the Federal Register].

By the Commission.

Robert W. Errett  
Deputy Secretary

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